

**UNIVERSITY OF CAPE TOWN
SCHOOL OF ADVANCED LEGAL STUDIES**

MINOR DISSERTATION

DEGREE: MASTER OF LAWS (LLM)

**TITLE: WHAT IS REALLY WRONG WITH INSIDER
TRADING?**

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**RESEARCH DISSERTATION PRESENTED FOR THE APPROVAL OF
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OF MASTER OF LAWS IN APPROVED COURSES AND A MINOR
DISSERTATION. THE OTHER PART OF THE REQUIREMENT FOR THIS
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ABSTRACT

Investments in a national economy are essential to stimulate economic growth and development, which in turn improves the living standards of its citizens. The stock market offers greater opportunities for investment by companies and international investors. Much has changed in securities trading with the advancement of technology and so with the ways fraud occurs on the market, ripping off assets of companies and ultimately investors. Corporate crimes are committed with the help of insiders who may be a director, employee or an officer of the company. Well functioning financial markets, proper criminal justice system and well-designed institutions, as well as regulatory systems facilitates investments and economic development.

The interrelationships between insider trading, investments and the overall economic activity in the corporate environment is a major concern and of interest to policy makers, economists, academics, businessmen and the public at large. Insider traders gain advantage of non-public information obtained from various sources within the management of the company to trade and make abnormal profits, which seem to be difficult to abate with all the laws in place. The paper examines some of the intricacies of insider trading. It is argued against the backdrop of the two schools of thought of prohibition or allowing insider trading in public listed companies, the extent to which insider trading regulation in South Africa has been effective in reducing private information trading.

CHAPTER 1

OVERVIEW OF INSIDER TRADING REGULATION

1.1 INTRODUCTION

The regulation of insider trading on the securities market is a subject matter of great interest to policy makers, investors and the general public. A public company listed on the JSE Securities Exchange and on any stock exchange have an advantage of raising more capital from the public but carries with it the risk of abuse by the corporate officers entrusted with the management of the company. They may trade in the securities of the company by making use of confidential information about the company's activities to make profit or avoid loss at the expense of outside investors. Price-sensitive information that is not available to the public is regarded as private or confidential information.

There has been much controversy about the use of confidential information about corporate activities in dealing in securities by persons having such non-public information and has been prohibited in most countries. The fact that controversy exist on the use of privileged information for dealing in securities on capital markets suggest that there is no single best answer to the problem of insider trading and will continue to keep the debate alive. The generally accepted view is that insider trading is wrong and it should be regulated. However, not everyone regards the regulation of insider trading as being desirable.

Proponents of insider trading argue that permitting insider trading would be an efficient compensation mechanism for corporate insiders for creating wealth.¹ They argue that allowing insider trading will provide an incentive to insiders for innovation and developing new products or encourage them to develop strategic plan to increase productivity which will lead to increase in the value of shares of the company and in turn benefit the shareholders.

¹ Henry G Manne *Insider Trading and the Stock Market* (New York: Free Press 1966) 138 – 141.

Ausubel discusses arguments in favour of insider trading and points out that if insider trading is permitted, insiders are motivated to gather more new information in order to make profit. As the insiders trade, the information gathered by them becomes rapidly reflected in the securities prices and this contributes to capital-asset pricing which leads to efficient markets.² It could be argued that even if this economic efficiency is accepted, it ignores the reality that insider trading damages investor confidence in the integrity of the financial markets.³

Insider trading is seen as commercially immoral and should be prohibited. It is argued that outside investors will be at a disadvantage and such insider trading malpractice may even drive away potential investors. The rationale being that investors will be reluctant to invest in a market where insiders trade on private information to make undue profits or avoid personal losses at their expense without legislative control. For example corporate insiders may engage in activities that may lower long-term value of the company and this will harm the investments of shareholders.⁴ They may undertake production and investment decisions that will increase the volatility of company's securities prices and destabilize the firm's performance in order take advantage of the price swings.⁵ This tends to discourage corporate investment and reduce market efficiency. Therefore regulation is deemed necessary to preserve confidence in the markets. 'Good corporate governance dictates that there should be rules regulating insider trading to prevent potential abuses by insiders and for companies to avoid being vicariously liable.'⁶

Regulators advance an argument against insider trading that it is a breach of fiduciary duty. Directors, managers and to some extent other employees become fiduciaries for the firms they manage on behalf of the shareholders.⁷ The insiders breach a fiduciary duty or other relationships of trust and confidence by trading in securities of the company based on material confidential information. A person owing a fiduciary duty should not use

² Lawrence M Ausubel 'Insider Trading in a Rational Expectations Economy' (1990) 80 *American Economic Review* 1022 at 1025.

³ MJ Fishman and KM Hagerty 'Insider Trading and the Efficiency of Stock Prices' (1992) 23 *RAND Journal of Economics* 106 at 106.

⁴ Alexandre Padilla 'Can Regulation Eliminate the Agency Problems Posed by Insider Trading?' (2005) 2 *Commentaries on Law & Economics* 47 at 50.

⁵ Ibid

⁶ Tshepo Mongalo et al *Forms of Business Enterprise: Theory, Structure and Operation* (Cape Town: New Africa Books, 2004) 304.

⁷ Jennifer Moore 'What is really Unethical about Insider Trading?' (1990) 9 *Journal of Business Ethics* 171 at 178.

corporate confidential information for personal gain and avoid conflicts of interests. Insiders trading on confidential information will affect the reputation of the company and the value of its securities.

Another justification for regulating insider trading is that it is a misappropriation of information amounting to theft of valuable corporate property from rightful owners.⁸ The misappropriation theory holds that the information used by insider traders is stolen as it belongs to the corporation. Whatever gain made by the insiders without the owner's permission belongs to it.

In South Africa, insider trading is a criminal offence and offenders may incur civil liabilities or both.⁹ The underlying philosophy banning insider trading in South Africa is contained in the statement of aims in section 2 of the Securities Services Act 36 of 2004 which includes increasing confidence in the South African financial markets, promoting the protection of regulated persons and clients, reduction of systematic risk and the promotion of international competitiveness of securities services in the Republic. Previous legislative attempts to regulate insider trading failed to yield successful prosecutions.¹⁰

1.1.1 PURPOSE OF THE RESEARCH

Although much work has been done by academics, lawyers and economists on insider trading and continues to attract attention from the media and government functionaries, certain questions are not yet satisfactorily answered. The paper examines some of the intricacies involved in the regulation of insider trading in order to ascertain what is really wrong with insider trading. The approach is three fold: firstly, it explores the historical developments, arguments in favour of insider trading and arguments offered as justification for the regulation of insider trading. Secondly, the South African legislation regulating insider trading is reviewed for potential weaknesses. Thirdly, it assesses the

⁸ RW Painter 'Insider Trading and the Stock Market Thirty Years Later', (1999) 50 (2) *Case Western Reserve Law Review* 305 at 305 - 306

⁹ Securities Services Act, 2004 (Act No.36 of 2004)

¹⁰ Tom Wixley & Geoff Everingham *Corporate Governance* 2ed (Cape Town: Siber Ink 2005) 37.

effectiveness of insider trading laws enforcement. The research is intended to make a modest contribution to knowledge and the development of the law in this field.

1.1.2 SCOPE OF THE STUDY

Chapter 1 gives a general overview of insider trading and covers the historical background of its regulation. It also explains the role of the stock market and information in relation to insider trading in the corporate environment.

Chapter 2 focuses on the arguments in favour of insider trading.

Chapter 3 gives an account of the arguments for the prohibition of insider trading regulation.

Chapter 4 examines key provisions in the South African law prohibiting insider trading and highlight its weakness.

Chapter 5 assesses the effectiveness of insider trading regulations. It touches on the challenges regulators encounter in the regulatory environment and examines records of insider trading laws enforcement.

Chapter 6 concludes the paper by highlighting the findings and its implications on issues relating to insider trading regulation.

1.2 CHARACTERISTICS OF INSIDER TRADING

Some trading in the securities of a company by corporate insiders is legal and others are illegal depending on whether there has been a breach of fiduciary duties or some relationship of trust and confidence or regulations governing the trading. Corporate insiders may be directors, officers or employees of the company.

Trading by insiders is legal when the corporate insiders buy and sell securities in their own company within the confines of the law. This depends on company policy, securities regulations and company law of a nation and other general enabling laws. In some companies, directors are offered share options as a form of remuneration and are able to trade in such securities. In the United States, the Securities and Exchange Commission (SEC) which oversees the regulation of securities, require insiders to report

when they trade in their own securities.¹¹ In South Africa, the Companies Act 61 of 1973 recognizes the ownership of securities by employees of their company.¹² Buying or selling of such securities is legal.

The concept of insider trading, is used to refer to the illegal form of buying and selling of securities when those corporate insiders in privileged positions who are in possession of confidential price-sensitive information about the company's activities trade and make profit for themselves or avoid losses or do so for other persons.

1.3 HISTORICAL BACKGROUND

The main function of a modern business organization is to maximize profits for investors and promote healthy economic co-operation among other stakeholders such as employees, suppliers, creditors, customers and the community at large. Any fraudulent activity by corporate insiders for personal gain or to serve selfish interest using confidential information about the company's activity, not only violates their duties of good faith, obedience, diligence and loyalty to the company and its shareholders, but it is capable of destroying the livelihood and interests of other stakeholders. This makes misuse of insider information reprehensible. Although, insider trading is as old as the stock exchange itself,¹³ its regulation intensified during the later part of the last century.

1.3.1 THE COMMON LAW

Directors are given wide discretion to oversee the smooth running of companies to achieve its objectives of incorporation but have a duty to use reasonable diligence to protect and safeguard corporate property. Companies generate a lot of information in the course of their business activities. Some of the information is confidential and the corporation has exclusive rights to it and the company is entitled to keep the information

¹¹ Gerald Acquah-Gaisie 'Toward more effective corporate governance mechanisms' (2005) 18 *Aust Jnl of Corp Law* 1 at 33.

¹² Section 38(2)(b) of the Companies Act recognizes ownership of securities by corporate insiders and a company may give financial assistance for the purchase of its own shares, in accordance with any scheme for the time being in force for employees of the company, including any director holding a salaried employment or office in the company.

¹³ Brenda Hannigan *Insider Dealing* (London: Kluwer Law Publishers, 1988) 1

obtained and assembled as private property.¹⁴ A director has a duty to protect this property of the company and he may not use it for his personal interests or unlawfully disclose trade secrets to any person. A director, employee or any officer of the company who abuses his position by making use of confidential information is to required account to the company and disgorge the profit made or loss avoided.

The law recognizes a company as a separate legal entity distinct from its owners. Directors control the company and its success or failure depends on them. They have access to management, company premises and all company information. The common law position on misuse of insider information is based on the decision in the English case of *Percival v Wright*,¹⁵ which established that a director of a company owes no general duty to the individual shareholders to disclose price-sensitive information to them but only to the company itself. The plaintiffs were shareholders of the company and offered to sell their shares to the directors of the company who were in possession of information about a pending take-over bid but kept it secret. After negotiations and completion of the transfers, the plaintiffs discovered that the directors knew the true value of their shares because of the information they had at their disposal and they sought to get the transaction set aside in order to avoid the transfer on the ground that the directors had a duty to disclose that information. It was held that there was no such duty. The decision has been criticized as being calamitous but has had remarkable career and tremendous impact on the development of company law in the common law jurisdiction of the world.¹⁶

The underlying principle in the decision being that the directors stand in a fiduciary relationship with regard to the company and owe their duties to the company as a whole. This expression has traditionally been used to mean the shareholders as a collective body. Thus, a director is in a position of trust and is obliged to act in the interest of the company and not in his own interests or that of shareholders as individuals. However, there may be circumstances where directors do owe fiduciary duties to the shareholders

¹⁴ William E Knepper *Liability of Corporate Officers and Directors* 3ed (Indianapolis, Indiana: The Allen Smith Co., 1978) 56 - 57

¹⁵ [1902] 2 Ch 421.

¹⁶ Aaron Yoran *Insider Trading in Israel and England* (Jerusalem: Alpha Press 1972) 1

individually requiring disclosure of information as decided by the Privy Council in *Allen v Hyatt*,¹⁷ as where the directors acted as the shareholders' agents.

United States courts have generally circumvented the decision in *Percival v Wright* by extending the categories of special circumstances requiring disclosure.¹⁸ In *Coleman v Myers*,¹⁹ the New Zealand Court of Appeal, held the directors liable to shareholders of a small family company in a take-over bid, where a fiduciary duty arose because of the special relationship that existed between them.

Recently, *Coleman v Myers* was approved and followed in the English case of *Platt v Platt*²⁰ at the first instance, where the court accepted counsel's submission that the directors' fiduciary duties carrying with them a duty of disclosure of insider information to shareholders in certain special circumstances existed because the director controlled the company's affairs and the other shareholders were dependent on him for information about its business and their shareholdings. On appeal, this point was not considered by the Court of Appeal but members of the court went out of their way and stated that it did not imply approval of the first instance decision.²¹ Therefore, it may be too early to write off *Percival v Wright* in the English jurisdiction.

In Australia, recognition was given to the existence of fiduciary relationship between directors and individual shareholders in *Glandon Pty Limited v Strata Consolidated Pty Limited*.²² The authority of *Percival v Wright* was abandoned in the New South Wales case of *Bunninghausen v Glavanics*.²³

South African common law treatment of insider trading is fundamentally the same as the English courts. A fiduciary relationship exists between the directors and a company. They are not obliged to disclose insider information to individual shareholders. Other corporate insiders, officers and employees in possession of information derived from a company which is not available to other investors are also not obliged to disclose to

¹⁷ (1914) 30 TLR 444 (PC).

¹⁸ Francis Rose *Company Law in a Nutshell* 5ed (London: Sweet & Maxwell 2001) 25

¹⁹ [1977] 2 NZLR 225.

²⁰ (ChD 1999) [1999] 2 BCLC 745; (CA 2000) [2001] 1 BCLC 698.

²¹ Ibid at 704 and 719

²² (1993) 11 ACLC 895.

²³ (1999) 46 NSWLR 538.

outsiders. However, South African judicial decisions may be influenced by Australian case law and give recognition of a fiduciary duty to shareholders in special circumstances where this duty would not compete with the fiduciary duty to the company. Blackman et al asserts that there is an indication that our courts may be prepared to depart from the rule in *Percival v Wright* and that it can no longer be categorically said that no fiduciary relationship exists between the director and the shareholders of his company.²⁴

1.3.2 STATUTORY CONTROL

Legislative attempts to regulate insider trading began in North America and later shifted to the rest of the world.

In the United States, insider trading became an offence with the passing of the Securities Act of 1933 and 1934 to restore public confidence in the markets after the 1929 stock market crash. The framework of securities regulation was created by the Securities Act of 1933 which required companies to make certain detailed disclosures before offering securities for sale in interstate commerce. Congress enacted the Securities Exchange Act of 1934 to regulate sales and purchases of securities and protect investors against manipulations and deceptions.²⁵

Provision was made in section 16(b) of the Exchange Act to deal specifically with insider trading by corporate insiders profiting from trading the stock market pricing inefficiencies of their company. Section 16(b) enables the company to recover any profits realized by an insider dealing in the securities of the company within any six-month period of the transaction. Then in 1942, the US Securities and Exchange Commission (SEC) which regulates securities trading on financial markets promulgated rule 10b-5 as an extension of section 10(b) of the Securities Exchange Act of 1934 as a residual anti-fraud prohibition.

²⁴ MS Blackman et al *Commentaries on the Companies Act* (Cape Town: Juta 2002-2005) Vol.1 at 5-389.

²⁵ Bernard Bergmans *Insider Information and Securities Trading: A legal and economic analysis of the foundations of liability in the U.S.A. and the European Community* (London: Graham & Trotman, 1991) 9.

Rule 10b-5 is a general anti-fraud provision which does not explicitly mention insider trading but it has been used the SEC and the courts to deal with fraud on the securities market and insider trading based on judicial interpretation of the rule. It states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

- (1) To employ any device, scheme or artifice to defraud,
- (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
- (3) To engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Under this famous Rule 10b-5, which outlaws deceptive practices, misstatements and half-truths, over the years has been used to shape US insider trading laws. Two legislation on insider trading passed by Congress, the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading Securities Fraud Enforcement Act of 1988 (ITSFEA) made enforcement more rigorous.

In Canada, the major legislative step taken to make insider trading illegal was the Attorney General's Committee on Securities Legislation in Ontario (Kimber Committee) recommendations of 1965 which were translated into legislation in the following year in the 1966 Ontario Securities Act. The provisions made for prohibition of insider trading in section 113 of the 1966 Act were substantially similar to the present section 131 of the Canada Business Corporations Act of 1985. Section 113 of the 1966 Act provided that "every insider of a corporation or associate or affiliate of such an insider, who in connection with a transaction" in corporate securities, "makes use of any specific confidential information" material to the value of the securities in question was liable to compensate "any person or company for any direct loss suffered by such person or company as a result of such transaction," and in addition, the defendant was "also accountable to the corporation for any benefit or advantage received or receivable...as a result of such transaction."²⁶

²⁶ FH Buckley et al *Corporations: Principles and Policies* 3ed (Toronto: Emond Montgomery Publications Ltd., 1995) 799

Insider trading regulation on the European continent took off in France with the introduction of *Ordonnance* 67-833 of 28 September 1967, which established the *Commission des Operations Bourse* and implemented reporting procedure following the pattern of section 16 of the American Securities Exchange Act of 1934.²⁷ Insider trading became a criminal offence there in 1970. The *Ordonnance* was amended in 1983, 1988 and 1989 with the view to widening its scope and improving its effectiveness for prosecution of offenders. The criminalization of insider trading in France received strong opposition against its regulation.

The French attempt inspired the European Commission (EC) to deal with the insider trading problem and generated interest in other European countries to follow suit. The EC proposal of a common standard in the early 70's to address insider trading problems in member states took a long time to finally come with a directive, the EC Insider Dealing Directive (Dir 89/592 [1989]) which has subsequently received some amendments and adopted by member states.

Germany introduced Insider Trading Guidelines in 1970 by the Commission of Stock Exchange Experts and the Ministry of Economy. This was amended in 1976 and 1988. The rules were optional and not mandatory. It had only voluntary codes against misuse of insider information and applied only to those companies and banks which expressly adopted. Prosecution of insiders was therefore limited to those business organizations which have voluntarily bound themselves to the guidelines.²⁸ This soft and voluntary approach received criticisms although they achieved some measure of success indirectly because they were used as the basis for disciplining of insider traders by their employers who have adopted and incorporated the Insider Trading Guidelines into contracts of employment.²⁹ Insider trading was criminalized in Germany in 1994 with the passing of the *Wertpapierhandelsgesetz* or Securities Trading Act which introduced the EC Insider Dealing Directive (Dir 89/592 [1989] OJ L334/30) into German law.³⁰

United Kingdom (UK) only passed a general legislation criminalizing insider trading or insider dealing (British terminology) for the first time in 1980. Provisions were made in

²⁷ Bergmans (note 25) at 67

²⁸ Ibid

²⁹ Mark Stamp and Carson Welsh (ed) *International Insider Dealing* (London: FT Law & Tax, 1996) 130.

³⁰ Ibid

Part V (sections 68 - 73) of the Companies Act of 1980 for the offence of insider dealing and those were re-enacted in the Company Securities (Insider Dealing) Act of 1985.³¹ The provisions supplement the equitable rules relating to directors' fiduciary duties. It was amended by the Financial Services Act of 1986. 'In 1989, a Directive (89/592/EEC) was adopted to coordinate regulations on insider dealing throughout the European Union. This has been implemented in the UK law by part V (ss 52 to 64) of the Criminal Justice Act 1993, which was brought into force on 1 March 1994 by SI 1994/242. The new law is more focused on the control the control of securities markets than the abuse of confidential information.'³²

In South Africa, insider trading became a statutory offence with the introduction of section 233 of the Companies Act 61 of 1973 following the Main Report (RP 45/1970) of the Van Wyk de Vries Commission of Enquiry into the Companies Act which was established in 1963 under the chairmanship of Justice Jan van Wyk de Vries. There was not a singular success of prosecution of insider trading offenders and legislation was repeatedly amended.³³

A Committee was established in 1995 by the Minister of Finance to investigate the insider trading provisions under the chairmanship of Mr Mervin King (SC). The King Task Group published its final report on 21 October 1997. A new legislation on insider trading was enacted following the recommendations of the Committee. The insider trading prohibition then contained in section 440F of the Companies Act was repealed by section 17 of the new Insider Trading Act 135 of 1998 in January 1999. Offences of insider trading were contained in section 2 of the Insider Trading Act. This legislation although made insider trading a criminal offence, also had no success of prosecutions. However, the JSE and the Financial Services Board intervened on a number of occasions and several directors paid fines without actually admitting guilt.³⁴

³¹ Stephen Mayson et al *Mayson, French & Ryan on Company Law* 20ed (Oxford: Oxford University Press 2003) 377

³² Ibid

³³ JG Van der Merwe et al *South African Corporate Business Administration* (Cape Town: Juta 1995 – 2005) 15-15

³⁴ Tom Wixley & Geoff Everingham (note 10) at 37.

The present legislation regulating insider trading, the Securities Services Act 36 of 2004 came into operation on 1 February 2005. Details of its provisions are discussed below in chapter 4.

1.4 ROLE OF THE STOCK MARKET

In studying the impact of insider trading in corporate environment, it is essential at this stage to examine the basic role of the stock market in the economy. Stock markets such as the JSE Securities Exchange help to stimulate growth and investment by bringing together companies and people who invest in them. It provides a financial market for the buying and selling of securities of companies and therefore the prevention of insider trading is seen as an important function of the stock market. As a result financial markets around the world and governments, devote significant resources to regulate insider trading. The primary aim of regulation is to achieve market efficiency.

1.4.1 THE EFFICIENT MARKET HYPOTHESIS

The stock market plays an important role in allocating capital and for it to operate efficiently and without inhibition, they require the confidence and respect from their own societies and increasingly, from the international community.³⁵ The stock market serves as an arena within which share values can be accurately or efficiently priced. However, 'stock price efficiency is not sufficient for economic efficiency; stock market efficiency may not be necessary for investment efficiency if the banking system can serve as an alternative institution for efficiently allocating investment resources.'³⁶ The ideal securities market is one which does a good job of allocating capital in the economy leading to a situation where the price of each security accurately reflects the risk and return in its future.

Active markets such as the New York Stock Exchange, London Stock Exchange and the JSE Securities Exchange are relatively efficient, made up of rational investors who react

³⁵ Barry Rider and Michael Ashe *Insider Crime: The New Law* (Bristol: Jordans, 1993) 6.

³⁶ WKS Wang and MI Steinberg *Insider Trading: 2000 Supplement* (New York: Aspen Law & Business, 2000) 7.

quickly and objectively to new information on the market. The **efficient market hypothesis** is a basic theory describing the behaviour of an assumed “perfect” market in which:

1. ‘Securities are typically in equilibrium, meaning that they are fairly priced and their expected returns equal their required returns.’³⁷ In competitive markets with many active participants, the interactions of many buyers and sellers using their assessment of an asset’s risk and return to determine its value, results in an equilibrium – the *market value* – for each security based on available information.³⁸
2. ‘At any point in time, security prices fully reflect all public information available about the firm and its securities, and these prices react swiftly to new information.’³⁹ That buyers and sellers are assumed to immediately digest new information and take informed decision.
3. Since stocks are fully and fairly priced, investors need not waste their time trying to find and capitalize on undervalued or overvalued securities.⁴⁰

The stock market can be *regarded* as an example of an efficient market since prices of stocks and shares are *fairly* determined by market forces of demand and supply. No one is mandated to influence price determination and the ruling price of shares is a reflection performance of the underlying fundamentals in the market. The stock market becomes efficient when information is readily disseminated to all market participants and it does not neglect any information relevant to the determination of security prices. Thus, information ought to be rationally and quickly conveyed into the share prices. Insider dealers may withhold valuable information which its release can affect determination of securities prices.

The JSE Securities Exchange functions as both a primary and secondary capital market.⁴¹ As a primary market, a public listed company issue new shares and debentures to raise capital and the proceeds go directly to the company. The shares may be issued to

³⁷ LJ Gitman *Principles of Managerial Finance* 9ed (Reading, Massachusetts: Addison-Wesley, 2000) 301.

³⁸ Ibid at 300.

³⁹ Ibid at 301.

⁴⁰ Ibid

⁴¹ JG Van der Merwe et al (note 33) at 5-1 to 5-3.

new shareholders or existing ones. As a secondary market in capital, the Securities Exchange facilitates the buying and selling of securities by existing shareholders or investors of a particular company.

Both the primary and the secondary markets offer opportunities for corporate insiders to cash in on price sensitive non-public information about the company's activities. The problem is acute in the secondary market. However, those in favour of allowing insider trading argue that when insiders trade on the secondary market, they speed up the flow of information and serve to feed their knowledge and forecasts into the prices, thus making the markets more efficient.

1.5 INFORMATION AND INSIDER TRADING

A company generates information merely by its legal existence through incorporation and more information is generated as it carries on with its business. The flow of information through the market is important for business transactions. Information about a company, commercial enterprise or any commodity is what the market relies on to determine its value or price. The more information about a company's activities, products or services that gets through to the market the better the public recognition it receives and this widens the scope of the market for that business organization. Just how valuable the information is, depends on the nature of the information and the number of people who know about it.

Information affecting securities prices of a company may be external or internal. The external information may be of international or national origin. Due to globalization, matters of international concern such as economic recession in major trading partners of a country and wide foreign exchange fluctuations on emerging markets may affect the securities market. 'On a national level, specific corporate information is the life-blood of any securities market because it can and does have a direct effect on the price of securities to which it relates. In many instances, such information will relate to matters of corporate economics; for instance, profit forecasts or warnings. It may relate to internal reorganisations within companies and could, for instance, detail any comings

and goings amongst board of directors or other employees.’⁴² In addition, the information could relate to external matters such as the trading or development plans of the company or its ideas for expansion as for example through takeovers and mergers.⁴³

Poor information dissemination on the stock market affects securities prices.

‘According to the efficient capital market hypothesis, all available information about a company’s financial prospects is fully and virtually instantaneously reflected in the market price of the company’s securities.’⁴⁴ Information asymmetry in the market results where there is uneven distribution of information among the market participants, some being more informed than others. It has been suggested that asymmetries introduces the possibility of profitable manipulation.⁴⁵ Corporate insiders are usually more informed or have quick access to information than outsiders. Those investors with very little information are referred to as noise traders. What insider traders do is to deal in price sensitive information which is not yet in the public domain to make profits or avoid losses.

Prior information in the possession of corporate insiders about public release of a company’s earnings, dividends, bond ratings, mergers, takeovers, and bankruptcies offer fertile grounds for insider trading activities. In addition announcement around major corporate events such as rights offer and release of information about results of research and development activities also create opportunities for insider trading.

Insider trading occurs when persons entrusted with the management of the corporation trade on non public price-sensitive information about the company’s activities to make a gain or avoid a loss at the expense of shareholders. The inadequacy of the common law to deal with insider trading problem led to the legislature to enact laws to regulate it. However, not everyone agrees to its regulation. The debate rages on.

The arguments in favour of insider trading are discussed in chapter 2.

⁴² Gil Brazier *Insider dealing: Law and Regulation* (London: Cavendish Publishing Ltd., 1996) 80.

⁴³ *Ibid* at 81.

⁴⁴ Hannigan (note 13) at 2.

⁴⁵ Franklin Allen and Gary Gorton ‘Stock price manipulation, market microstructure and asymmetric information’ (1992) 36 *European Economic Review* 624 at 629.

CHAPTER 2

ARGUMENTS AGAINST THE REGULATION OF INSIDER TRADING

Advocates of insider trading deregulation argue that there is nothing wrong with it and they claim its overall impact is positive. The various arguments raised in favour of insider trading are discussed below.

2.1 EFFICIENT AND LEGITIMATE MEANS OF COMPENSATION

Henry Manne denounced the notion of inherent unfairness of insider trading 40 years ago and argued that insider trading does not harm investors and can indeed be an efficient way of compensating insiders when they enhance an issuer's stock price.⁴⁶ Numerous studies, such as by Dye, and Carlton and Fischel among others also conclude that insider trading may be a way for firms to compensate management optimally.⁴⁷ Manne and others argue that by allowing insider trading it will provide the insiders with an incentive to innovation for developing new products or strategic plans to increase productivity. They argue that permitting insider trading; the interests of the insiders will be aligned with that of the company. The corporate insiders may find it beneficial to enhance corporate risk taking thereby developing growth opportunities which will increase the value of shares of the company and in turn will benefit the shareholders.

The argument that insider trading provides a powerful incentive for corporate officers for creative and entrepreneurial activity has been criticized as flawed, since a person who benefits from trading on inside information is not necessarily the person responsible for innovation.⁴⁸ '[I]nsider trading does not necessarily reward that person in proportion to the value of any innovation; and insider trading allows insiders to profit from trading in anticipation of corporate failures as well as corporate successes. Moreover, the

⁴⁶ Henry G Manne 'In Defense of Insider Trading' (1966) 44 (6) *Harvard Bus. Rev.* 113 at 116 – 118.

⁴⁷ Ronald A Dye 'Insider Trading and incentives' (1984) 57 (3) *Journal of Business* 295;
DW Carlton and DR Fischel 'The regulation of Insider Trading' (1983) 35 *Stanford Law Review* 857.

⁴⁸ Ashley Black 'The Reform of the Insider Trading Law in Australia' (1992) 15 *UNSW Law Journal* 214 at 219.

possibility of earning profits from insider trading may encourage corporate insiders to withhold information from the market so as to serve the insider's trading interests. The result would be that the market is misinformed and to the extent of that misinformation, inefficient.⁴⁹ Where insider trading is permitted, there will be a temptation for those responsible for ensuring prompt disclosure of price-sensitive information to delay its disclosure and manipulate it to their advantage before disclosing it to the public.

Proponents argue that by permitting insider trading the company will be able to cut down on expenditure by paying lower remuneration formally to directors, managers and other corporate employees in the form of salary and bonuses. This it is believed will be a set off against the profit made by the insiders. However, this argument fails to address the critical issues of corporate insiders exposing the company to danger of threats of takeover bids by undertaking risky or ill-advised business activities involving investment and production decisions to destabilize the firm's performance to take advantage of stock price oscillations in order to make unfair profits at the expense of shareholders. It also ignores the practical reality that insider trading damages investor confidence in securities trading, which is an important component of the proper functioning of the stock market.⁵⁰

It has been argued that if permitting insider trading is to work as suggested by its proponents then there must be a direct and consistent link between the profits reaped by the insider traders and the performance that benefits the corporation.⁵¹ However, there are situations whereby insider traders may profit from trading on inside information without any benefit accruing to the company; suggesting that permitting insider trading will not necessarily serve as an incentive for improved performance and link the interests of directors, managers and employees to the company as whole. It is usually assumed by proponents of insider trading that the easiest way to profit on inside information is to create it by adding value to the company's productive activities.⁵² This requires a significant investment of time and energy on the part of the insider to generate new information in order to profit from inside trading. It is argued that it would be equally profitable and far easier for the insider to start a rumour that the company has a

⁴⁹ Ibid

⁵⁰ Ibid at 220.

⁵¹ Moore (note7) at 178.

⁵² Ibid at 179.

new product or about to announce a deal and trade on such information rather than actually inventing a new product.⁵³ This “invention” of information and stock manipulation will not benefit the company and the society at large.

Proponents of insider trading often regard information creation as positive such as making a new deal or that an important new customer has been acquired, that there will be an unanticipated takeover bid or acquisition, developing a new product or that there has been a significant technological breakthrough and finding a new and efficient way of conducting business in which case permitting insider trading will serve as an incentive for insiders to work harder for the good of the company.⁵⁴ However, insiders can also trade and profit on negative information such as an impending large law suit against the firm that is likely to reduce significantly the firm’s value, an unsafe or poor quality product withdrawal from the market and lower than expected performance or the cancellation of an important contract.⁵⁵ Thus, both negative and positive corporate information can be valuable to an insider trader. Seemingly, where insider trading is allowed, positive information encourages insiders to perform acts which are beneficial to the company and by analogous reasoning negative information would encourage harmful acts. Consequently, permitting insiders to profit from harms to the company decreases the incentive to avoid such harms.

‘Even if negative or false information did not pose problems, the incentive argument for insider trading overlooks the difficulties posed by “free riders” — those who do not actually contribute to the creation of the information, but who nevertheless aware of it and can profit by trading on it. It is a commonplace of economic theory that if persons can benefit from a good without paying for it, they will generally do so. If there is no way to exclude those who do not “pay” from enjoying a benefit, no one will have an incentive to pay for it, and the good will not be supplied. In the case of insider trading, an employee’s contribution to the creation of positive information constitutes the “payment.” Unless those who do not contribute can be excluded from trading on it, there will be no incentive to produce the desired information; it will not get created at

⁵³ Ibid at 178.

⁵⁴ Ibid

⁵⁵ Ibid

all.⁵⁶ Excluding non-contributors will not only be costly but will in practice restrict insider trading and defeat the very intentions of the proponents of insider trading.

Martin and Peterson argue that corporate executives should not be allowed to trade on inside information because they earn higher salaries.⁵⁷ In addition if higher corporate profitability results, executives who are paid relative to performance receive greater remuneration via stock options and other bonuses.⁵⁸ Moreover, the cost of allowing non-disclosure of material information exceeds the benefit of increased incentive to produce the information.⁵⁹

Insider trading has the potential of exposing the company to financial difficulties, fraud and even corporate failure. This has implications for corporate governance. Good corporate governance plays a vital role in underpinning the integrity and efficiency of financial markets.⁶⁰ Companies with track record of good corporate governance and performance are able to attract capital from investors. So do countries with good corporate governance systems in place are able to attract capital from foreign investors. Therefore, allowing insider trading with the view to compensating insiders will create inefficiencies in the corporate environment and the financial system of a country's economy.

2.2 OPTIMAL DISCLOSURE AND INFORMATIONALLY EFFICIENT STOCK PRICES

Information plays an important role in an economy. It assists in driving the pricing mechanism essential to economic efficiency.⁶¹ 'When market prices incorporate all relevant information, the market allocates resources optimally and corporate managers make efficient production decisions.'⁶² Companies generate a lot of information as they

⁵⁶ Ibid at 179.

⁵⁷ DW Martin and JH Peterson 'Insider Trading Revisited' (1991) 10 *Journal of Business Ethics* 57 at 59.

⁵⁸ Ibid

⁵⁹ Stephen Bainbridge 'The Insider Trading Prohibition: A Legal and Economic Enigma' (1986) 38 *University of Florida Law Review* 35 at 56.

⁶⁰ Discussion of the need for good corporate governance on the website of OECD (Organization for Economic Co-operation and Development) <http://www.oecd.org> (accessed 11 August 2006).

⁶¹ Jonathan EA ten Oever 'Insider Trading and the Dual Role of Information' (1996) 106 *Yale Law Journal* 1325 at 1328.

⁶² Ibid

carry on with their business activities. The information produced is a commodity, and which can be bargained for within the market structure. 'Information is gathered only when it is cost effective to do so, i.e., when its market value exceeds its cost of production. To capture this value, the producer of the information must restrict its availability.'⁶³ Therefore various mechanisms are put in place by companies in the management of their information systems.

The extent to which information is made available on the market influences the degree of economic efficiency. The more information is available the greater the economic efficiency. 'Market participants have no incentive to produce information unless they are allowed to profit from its production. This profit is a transaction cost, undermining economic efficiency.'⁶⁴ Companies produce information to profit from it. Corporate insiders may gather information in the course of performance and fulfilling their duties regardless of potential trading profits. It is argued that where insider trading is allowed, insiders will be motivated to gather more new information in order to profit from.⁶⁵ This it is suggested will contribute to complete, instantaneous and more information been made available on the market. Ausubel writes:

[I]f insiders are permitted to trade freely on their private information, then information becomes more rapidly reflected in securities prices. Insider trading thus contributes to efficient markets and so to allocational efficiency, as proper capital-asset pricing leads to the optimal allocation of capital resources.⁶⁶

However, there is a contrasting view which contends that insiders withhold and manipulate information in order to cash in thereby distorting market efficiency.⁶⁷ 'Because trading profits depend on control over information, there is no guarantee that the originators of successful projects will reap the rewards. Indeed, insider trading might be expected to induce a variety of perverse behaviours by managers who would compete to acquire and hoard information within the firm.'⁶⁸

⁶³ Ibid

⁶⁴ Ibid

⁶⁵ LM Ausubel (note 2) at 1025.

⁶⁶ Ibid

⁶⁷ LN Benny 'A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading' (September 1999) *Harvard Law School, Discussion Paper No.264* at 15. Available at http://www.law.harvard.edu/Programs/olin_center/ (accessed 30 August 2006).

⁶⁸ Ibid

Public companies listed on the stock market are expected to disclose certain information timeously as stipulated in the listing requirements of the particular stock exchange and in the company's articles of association. For example, section 9 of the JSE Listing Requirements stipulates that certain transactions, principally acquisitions and disposals, by issuers must publish an announcement of the details of such transactions as soon as possible after its terms have been agreed by the parties to the transactions.⁶⁹ This is to ensure all market participants have equal access to relevant information about the securities of the company, prevent insider trading and maintain efficient operation of the market.

It has been argued that complete disclosure would not be optimal as information disclosure is costly and sometimes the costs outweigh the benefits of the increased disclosure.⁷⁰ Shareholders value the ability of managers to control and effectively communicate information to the stock market. Proponents of insider trading contend that '[i]nsider trading serves as a means of communicating market information, which makes markets more efficient'.⁷¹ Insiders might have access to the privileged information because of their position in the company. When insiders trade in securities on the secondary market, they speed up the flow of information and feed their knowledge into prices, thereby making market more efficient.⁷² If insider trading is permitted and insiders with fore knowledge trade in the securities of their company, it will signal to outsiders observing the price movements to infer that the insiders are optimistic about the company's future prospects and may in turn buy shares which may cause the price move in a certain direction.⁷³ In this way, the insider trading activity would have caused the price movement in the direction of their correct levels without disclosing sensitive information. Thus, a company can use insider trading as a tool of communicating changes in fortunes to the market.

⁶⁹ JSE Limited Listing Requirements, available at www.jse.co.za (accessed 10 January 2007).

⁷⁰ Ibid

⁷¹ Robert W McGee & Walter E Block 'Information, Privilege, Opportunity and Insider Trading' (1989) 10 *Northern Illinois University Law Review* 1 at 11.

⁷² MG Velasquez *Business Ethics: Concepts and Cases* 5ed (Upper Saddle River, NJ: Prentice Hall, 2002) 454.

⁷³ Ibid

If, for example, insiders such as the Chief Executive Officer and the Chairman of a large public listed company buy large quantity of shares at a go or as intermittent purchases through their brokers and the information filters through to other brokers it will portray as an evidence of possible rise in the company's share price in the short run. Similarly, if they sell their shares in the same manner, it will give an impression of possible decline in the share prices in the near future. This is likely to generate a chain reaction and cause share prices to move closer to its true market value without the need for public announcement as the market reacts immediately. McGee and Block contend that, even if the insider is anonymous, an increase or decrease in demand for the securities in question will be noticed by the market and the price movement will respond accordingly.⁷⁴ Prohibiting insider trading will therefore prevent this flow of information. It is argued that there may be valid reasons why at times companies cannot disclose information about their future earning prospects and other privileged information especially if it will harm the company.

Information asymmetry exists on the market where there is unequal access to information for all market participants. Corporate insiders have access to more information than outside investors. Insider trading as a result of information asymmetry therefore causes disparity of power in trading among buyers and sellers of securities. This has the potential of causing distortions in efficient operations of capital markets.⁷⁵ Information asymmetry increases the risks assumed by the less informed party and this has the tendency creating a warping effect on utility functions.

Manove asserts that even when insider trading is informative and could be a channel of communicating information; it would often be preferable if insider information were communicated directly to the public rather than through the stock market.⁷⁶ For example headline news such as "XYZ Discovers Large Deposits of Petroleum to Meet Needs of the Country for 30 years" may be a more efficient way of communicating information to the investing public than an unexplained rise in the price of the securities of the firm through the trading activities of insiders.

⁷⁴ Ibid

⁷⁵ JR Macey and Maureen O'Hara, 'From Markets to Venues: Securities Regulation in an Evolving World' (2005) 58 *Stanford Law Rev.* 563 at 588-9.

⁷⁶ Michael Manove 'The Harm from Insider Trading and Informed Speculation' (1989) 104 (4) *The Quarterly Journal of Economics* 823 at 843.

It is better for companies to disclose relevant information to investors rather than allowing insiders to trade for the information to reflect in the securities prices. If insider trading is permitted, insiders may withhold information and distort market efficiency.

2.3 INSIDER TRADING LAWS INEFFECTIVE AND DIFFICULT TO ENFORCE.

Globalization and technological advances have facilitated internationalization of capital markets, but they also present new opportunities for insider trading, thus expanding the need for effective regulation.⁷⁷ Opponents of the prohibition of insider trading argue that insider trading legislation is ineffective and difficult to enforce.⁷⁸ The regulation of insider trading has had little impact on securities market.⁷⁹ Existing laws on insider trading require insiders either to abstain from trading on confidential information or to release such information to the public before they trade. It is argued that insider trading is inherently difficult to investigate as well proving such insider trading cases and as a result significant amount of clearly illegal activity goes undetected or unpunished.⁸⁰ 'Insider trading is an extraordinary crime to prove. The underlying act of buying and selling securities is, of course legal activity. It is only what is in the mind of the trader that can make this legal activity a prohibited act of insider trading.'⁸¹

The prosecution of insider trading offence was not very common until the second half of the last century.⁸² In the USA, '[b]etween 1966 and 1980 the SEC filed only thirty seven cases of insider trading, and twenty-five of them were settled out of court; that is an average of 2.6 cases per year, and the SEC sought or obtained disgorgement of profits in twelve of these.'⁸³ The reported cases pursued by the SEC figures increased in the

⁷⁷ MS Caccese 'Insider Trading Laws and the Role of Securities Analysts' (1997) 53(2) *Financial Analysts Journal* 9 at 9.

⁷⁸ Lori Semaan, MA Freeman & Mark Adams 'Is Insider Trading a Necessary Evil for Efficient Markets?: An International Comparative Analysis' (1999) 17 *CSLJ* 220 at 226 – 227.

⁷⁹ *Ibid*

⁸⁰ Thomas C Newkirk & Melissa A Robertson 'Speech by SEC Staff: Insider Trading – A U.S. Perspective' Remarks at the 16th International Symposium on Economic Crime, Jesus College, Cambridge, England (19 September 1998). Available at: <http://www.sec.gov/speech/speecharchive/1998/spch221.htm> (Accessed 9 June 2006) p.2 of 19.

⁸¹ *Ibid* at 10.

⁸² Jie Hu and TH Noe 'The Insider Trading Debate' 1997 Federal Reserve Bank of Atlanta *Economic Review* Fourth Quarter 34 at 35.

⁸³ *Ibid*

1980's with the tightening of regulation laws. However, it was reported that despite the SEC's efforts to curtail insider trading, there was evidence to suggest active insider trading and insider trading profits were excessive relative to the average market return.⁸⁴

In the UK, Criminal Justice Act 1993, sections 52-64 makes insider dealing in shares on a regulated market or through professional intermediary a criminal offence punishable with up to seven years imprisonment. Companies and other legal persons cannot be guilty of insider dealing under this Act but individual directors or officers of listed companies who procure the offence or encourage the company to do so commit a criminal offence. Legal persons such as companies are exempted the rationale being an acknowledgement of the fact that it will be difficult to implement the legislation and proof insider trading without making it onerous for companies to comply. For example difficulties arise when one department of a corporate body (eg a merchant bank) has non-public price-sensitive information about a client and another department without the information deals in the securities of that client. It is a single legal person and therefore criminally liable. But it may put up a defence of having 'Chinese Wall', an internal arrangement which satisfies the legislative requirements to ensure that no inside information is communicated between the department dealing in the securities on behalf of the company and the department possessing the inside information. It will be no breach of insider trading offence if the legal requirements are met.

On the monitoring, enforcement and prosecution there has been few convictions under the UK insider dealing legislation.⁸⁵ However, it has been argued that the relatively small number of convictions since 1980 is not a failure of the legislation in curbing insider dealing. Rather, it is regarded as having played an important part in changing attitudes to the proper use of information, with the effect that insider dealing is seen universally as wrong, which was not the case when it was first made illegal in 1980.⁸⁶

In South Africa, there hasn't been any conviction for insider trading offences.⁸⁷ Is it confirming the long viewed perception that insider trading laws are ineffective or overly legalistic and extremely difficult to obtain a conviction? It has been reported that a

⁸⁴ Ibid

⁸⁵ Brazier (note 42) at 161.

⁸⁶ Ibid

⁸⁷ See text on note 34.

change of attitude towards insider trading as being unacceptable has contributed to the low incidence of insider trading in South Africa.⁸⁸ ‘Insider trading is no longer a hip in SA. That’s according to a new report by the Insider Trading Directorate (ITD), which surveyed a range of the country’s financial and legal firms and found that 80% felt that insider trading had become markedly less acceptable. The survey included actively traded listed companies, member firms of the JSE Securities Exchange, asset management companies, and corporate finance, audit and law firms. It aimed to assess the impact of anti-insider trading measures taken since South Africa’s Insider Trading Act took effect in January 1999. “The new regime has changed prevailing attitudes to insider trading, resulted in new policies and approaches among listed corporates and their advisers, and – according to most market participants – led to a sharp reduction in the perceived incidence of insider trading”, said ITD chair Rob Barrow.’⁸⁹

Successful prosecution of insider trading cases are few because of the inherent difficulty in obtaining evidence and proving the *mens rea* for the crime.

2.4 VICTIMLESS

Proponents of insider trading deregulation argue that insider trading is a victimless act and that enforcing insider trading prohibitions is simply not cost effective; the amount of money which is recovered does not justify the money spent on investigating and prosecuting insider traders.⁹⁰ According to this point of view, buying and selling of securities is a consensual act which the parties to the transaction agree to trade with no prior contract to have access to equal information nor which require a party to refrain from trading if equal knowledge is not possessed. Thus, asymmetric information should not be a basis of illegality in a trade involving a willing buyer and a willing seller.

In equities trading, it may be true to some extent that public shareholders’ transactions would have taken place whether or not an insider was unlawfully trading in the market.⁹¹ It could be argued that since the traders willingly accept to take the risk that the party on

⁸⁸ South Africa.info reporter, ‘Insider trading out in SA’ 26 August 2004
Available at <http://www.southafrica.info> (accessed 4 August 2006).

⁸⁹ Ibid

⁹⁰ Newkirk & Robertson (note 80) at 3.

⁹¹ Ibid

the other side of the trade is more knowledgeable, no one's rights are violated. 'If no one's rights are violated, the act is not unjust; if someone's rights are violated the act is unjust.'⁹² This raises the obvious question of whose rights are violated by insider trading.

McGee and Block points out that the obvious potential victims of insider trading are the potential sellers who sell their stock anonymously to an insider trader but discount that they would have sold anyway whether the inside trader bought from them or not; in which case it does not affect the proceeds they receive.⁹³ They argue that it is difficult to measure any damage done to the sellers if the sellers are hurt at all by having an inside trader in the market.⁹⁴ 'In fact, academic literature recognizes that insider trading does not result in any harm to any identifiable group, and those who sell to inside traders may actually be helped rather than harmed because they receive a better price.'⁹⁵ They argue that since there appears to be no violation of anyone's rights in such instances of insider trading, it will appear illogical to allow for anyone to sue for damages.⁹⁶

Trading in options market presents a different scenario; in that professional option writers write options only in response to a particular demand. If the demand is made by an insider possessing price-sensitive non-public information, the option writer suffers a loss that would not have occurred.⁹⁷

Outside investors as a group, it is argued stand to lose. 'The losses of outside group are caused by the fact that insiders take advantage of price movements. If a group of traders participated equally in all price moves, the group would perform as well as the market. Insiders, however, cause outsiders as group to hold less stock before price rises and more before price drops. An example may clarify how outsiders lose as much as insiders gain. Assume a firm with a total capitalization of \$100, \$90 of which are held by outsiders and \$10 by insiders. Insiders, predicting a price drop, sell \$5 of their holdings, resulting in their holding of \$5 for the outsiders' \$95. Insiders' expectations

⁹² McGee &Block (note 71) at 9.

⁹³ Ibid

⁹⁴ Ibid

⁹⁵ Ibid

⁹⁶ Ibid at 10.

⁹⁷ Newkirk & Robertson (note 80) at 3.

materialize and the market falls 20%, leaving outsiders with 95% of \$80, or \$76, and insiders with \$4.⁹⁸

Employers are harmed by insider trading when corporate employees misappropriate information for personal financial gains. As a result they become victims of insider trading. In this circumstance if the perpetrator could be identified, then the company will have recourse at law to sue the employee. Since it is a private right violation and not a public harm it would appear illogical for the government to be a party to the suit involving insider trading.⁹⁹

It seems to suggest that the primary victims of insider trading are outsiders who traded with insiders and remedies should be limited to privity of contract. However, traders and secondary victims on the stock market are diverse and dispersed. The fact that one person is not specifically harmed in trading on the stock market does not mean that the broader society is not harmed. The practice of insider trading is regarded as a fraud on the market. When people suspect insider trading is rife, they may lose confidence and invest less in the market or leave the market.¹⁰⁰ This will have the effect of reducing the market size and depriving companies the opportunity of raising capital to fund future expansion projects. Ultimately the reduced market size harms everyone in the market and the society in general.¹⁰¹ 'The reduced size of the market will have a number of harmful effects, including (a) a decline in the liquidity of stocks because it is harder to find buyers and sellers for stock; (b) an increase in the variability of stock prices because small variations will make relatively larger differences in the smaller market; (c) a decline in the market's ability to spread risk because there are fewer parties among whom to spread risks; (d) a decline in market efficiency due to the reduced number of buyers and sellers; and (e) a decline in the utility gains available to traders because of the decline in available traders.'¹⁰²

⁹⁸ Wang and Steinberg (note 36) at 22.

⁹⁹ McGee & Block (note 71) at 10.

¹⁰⁰ Velasquez (note 72) at 456.

¹⁰¹ Ibid

¹⁰² Ibid

Insider trading also has the harmful effect of increasing transaction costs in the course of buying and selling of securities.¹⁰³ Trading in securities on the stock market is done through intermediaries such as merchant banks and other stockbrokers who charge a fee for their services. Some buy and hold their stocks for sale to those who may want to buy later. When insiders dispose off their securities to the intermediaries which turn out to be worthless, a natural consequence is for the intermediary to raise his fees in future trades to cover the losses and this makes it costly to trade in securities. In an extreme case, the costs may rise so high to the extent that the market in a stock breaks down completely or in a less extreme case the rising costs will merely make the stock market just much more inefficient.¹⁰⁴ Insider trading undermines the proper functioning of the markets and harms all those who have a direct or indirect interest in the efficiency of the markets. This involves everyone as trading on the stock market affects our lives in one way or the other.

External costs emanating from loss of investor confidence as a result of unchecked insider trading can affect the economy by keeping away foreign investors thereby depriving it the much needed foreign investment. The state has an important role to play in protecting the proper functioning of the capital market. Large volumes of transactions takes place in a day's trading on the securities exchange which goes through a complicated computer-assisted electronic trading system. Therefore it will be difficult to link up buyers and sellers to address issues of civil liability. If it were possible to link up who sold securities to whom on the securities exchange, becoming a competent claimant would be a little bit like winning a lottery.¹⁰⁵ Rider contends that law is the proper tool for protecting the proper functioning of markets whether in securities or other forms of property.¹⁰⁶ It is argued that insider trading harms the society's overall utilities and prevents the goal of involving more people in the "ownership of society".

The regulation of insider trading started in the United States after the stock market crash in 1929. The regulation spread to other parts of the world. Over the years, the arguments against the prohibition of insider trading have been put forward but haven't succeeded in convincing various jurisdictions to deregulate insider trading. Today, most

¹⁰³ Ibid

¹⁰⁴ Ibid

¹⁰⁵ Buckley et al (note 26) at 802.

¹⁰⁶ Barry Rider *Insider Crime: The Law* Bristol: Jordans 1992) 6.

countries around the world with financial markets have legislation prohibiting insider trading suggesting that the arguments against insider trading are not good enough to warrant deregulation. The arguments for prohibiting insider trading are discussed in chapter 3.

CHAPTER 3

ARGUMENTS FOR PROHIBITION OF INSIDER TRADING

Insider trading is prohibited on most stock markets around the world. ‘The goal of securities regulation in general, and insider trading regulation in particular, is to promote full and fair disclosure and create transparent capital markets.’¹⁰⁷ Insider trading prohibition has traditionally been justified on the grounds that it offends basic notions of fairness and jeopardizes the integrity of the capital markets. Bollen asserts that the basis of the prohibition of insider trading in most international regimes comprises one of the following: market efficiency, fairness, fiduciary duty and misappropriation.¹⁰⁸ The various arguments advanced to justify the prohibition of insider trading are discussed below.

3.1 MARKET EFFICIENCY

The prohibition based on the premise that insider trading is damaging to the efficient operation of the financial market. The market efficiency concept largely based on market price firm’s stock, how securities prices react to new information and aggregate social welfare. The financial theory called the *efficient capital market hypothesis* has been a useful tool for analysis. The theory has been used somewhat differently, but in its most widely accepted form holds that, when a competitive market exists for securities, all public information about prospects for the firm will be fully and virtually instantaneously reflected in the market price of the securities.¹⁰⁹ Put differently, the efficient market theory posits that the prices of securities in financial markets should reflect all available information. ‘An efficient securities market is one in which the price of a stock at a given time is the best estimate of what the price will be in the future. In its weakest form, it says that nothing in the sequence of past stock prices enables investors to predict future price movements; the semi-strong form asserts that all publicly available information about issuers is reflected in stock prices, whereas according to the

¹⁰⁷ Caccese (note 77) at 9.

¹⁰⁸ Rhys Bollen ‘Research Analysts and the Australian Market Misconduct Regime’ (2003) 10 (2) *Murdoch University Electronic Journal of Law* at 7. Available at http://www.murdoch.edu.au/elaw/issues/v10n2/bollen102_text.html (accessed 31 July 2006).

¹⁰⁹ Buckley et al (note 26) at 5.

strong form, even non public information is translated into the prices. In an efficient market, public announcements will immediately affect the price of a security. In order to achieve maximum efficiency, the most prompt disclosure possible of material information is therefore necessary.’¹¹⁰

An efficient market will be transparent and this will enable all market participants to have equal access to relevant information about the securities of a company to analyze and take rational decisions for their investments. Securities regulation laws are intended to facilitate the dissemination of all relevant information to assist in the determination of the market price of securities. However, in practice not all material information are disclosed and information required to be supplied almost always lags behind significant new information about a publicly traded company.¹¹¹ There has been a decline in the influence of the efficient market theory as a determinant of stock price and it is now recognized that stock prices are at best, only a very rough indicator of full economic value of a company’s shares.¹¹²

The stock market efficiency concept has two components, namely, the **speed** and **accuracy** with which information about the securities of a company gets to the market and reflected in its prices.¹¹³ ‘The more efficiently information about a security is reflected in price, the more efficient the market for that security is thought to be.’¹¹⁴ It is unclear the extent to which information quickly becomes public with or without insider trading. What is clear though, is that market prices are more accurate once the information is released.¹¹⁵ Securities prices move up and down as new, unexpected information enters the market. However, some types of information that are highly relevant to assessing the economic value of the securities of companies appear to be incorporated into prices far more slowly and incompletely than the conventional view of market efficiency would suggest.

¹¹⁰ Bergmans (note 25) at 105-106.

¹¹¹ Bergmans (note 25) at 106.

¹¹² LA Stout ‘Takeovers in the Ivory: How Academics Are Learning Martin Lipton May Be Right’ (2005) 60 *The Business Lawyer* 1435 at 1444.

¹¹³ JR Macey ‘Securities Trading: A Contractual Perspective’ (1999) 50 *Case Western Reserve Law Review* 269 at 275.

¹¹⁴ *Ibid*

¹¹⁵ *Ibid* at 276.

An example of an apparently incomplete and delayed response of market prices to new information is the “post-earnings-announcement-drift” that occurs when a company announces an unanticipated increase in earnings, which tend to be followed by abnormal positive returns in the firm’s stock over the next several months.¹¹⁶ On the other hand, companies that announce bad earnings news see abnormal negative returns over an extended period.¹¹⁷ This has led commentators to conclude that the initial price response to the new earnings information is incomplete and that the full implications of the new earnings information are digested by the markets far more slowly than previously suspected.¹¹⁸

Insiders may influence the operation of an efficient market as for example when they delay the disclosure of price-sensitive information in order to give themselves more time to trade or permitting them to implement a trading strategy to extract maximum gain from the use of the information.¹¹⁹ Macey writes:

[I]t might be best, from the point of view of an insider with non-public positive information, to make a series of small purchases of stock (or derivative) over a relatively protracted period of time in order to minimize the price impact of such purchases. This tactic allows insiders to minimize their acquisition costs by reducing the price impact of their purchases. By stringing out their purchases or sales over a long period of time, insiders could minimize the effects of their purchases on average trading volume in order to impede the ability of market professionals to “decode” the information being conveyed by the insider’s trading.¹²⁰

Insider trading may impact on market efficiency as it has an effect on the transaction costs market participants have to bear. Insider traders have informational advantage over other investors in the securities of a company. The superior information of insiders generates informational asymmetry on capital markets. Asymmetric information increases the cost of trading. ‘[A] growing body of economic literature on market microstructure suggests that insider trading on non-public information might reduce

¹¹⁶ LA Stout ‘Stock prices and Social Wealth’ (November 2000) *Harvard Law School, Discussion Paper No. 301* at 10. Available at http://www.law.harvard.edu/programs/olin_centre/ (accessed 30 September 2006).

¹¹⁷ Ibid

¹¹⁸ Ibid

¹¹⁹ Macey (note 113) at 276.

¹²⁰ Ibid

market liquidity.¹²¹ Reduced market liquidity implies higher trading costs. Exchange specialist and other market makers bear a transaction cost when insider dealers dispose off securities to them. This cost is passed on to traders or investors in the bid-asked spread quoted by exchange specialist and other market makers. Thus, they subsidize their losses vis-à-vis insider traders by charging liquidity traders an immediacy fee.¹²² The fee charged is the bid-ask spread. 'The greater the degree of asymmetric information, the greater the bid-ask spread (i.e., cost of trading). This logic suggests that, because insider trading is a type of informed trading, the greater its incidence, the higher are the costs of trading for uninformed investors and hence the lower is market liquidity.'¹²³

Investors have a rational expectation that they will earn fair returns on their investments. Permitting insider trading could create opportunities for exploitation of the market by insiders at the expense of shareholders or outside investors. If investors have reasons to believe that insider trading exists and insiders having informational advantage will gain more at their expense, they may reduce their investment in the securities of that company. Local and foreign investors as well may not participate in such markets. The reduced investment will have chilling effect on the overall liquidity of financial markets and the ability of companies to raise capital. This will affect the allocation of resources and hence attainment of market efficiency.

The market efficiency rationale for regulating insider trading is based on the premise that insider trading may damage financial markets. Insider trading makes the market inefficient and raises cost of capital for issuers of securities thereby decreasing the overall economic growth of a country. Therefore regulating insider trading makes the market efficient. An efficient market attracts more investors, which translate into market liquidity and thus economic growth.

3.2 FIDUCIARY DUTY

Regulators of insider trading point out that corporate insider owe a fiduciary duty to

¹²¹ Benny (note 67) at 15.

¹²² Ibid

¹²³ Ibid

shareholders. The fiduciary duty theory posits that insiders, by virtue of their office or relationship with the company have a standing obligation to enhance the interest of the company and its members or shareholders. The orthodox legal position of fiduciary duty in corporate governance is that directors being the principal management organ of the company owe fiduciary duties to the company but do not owe fiduciary duties to shareholders, employees, creditors or the members of any other constituency which may have some interest in the company's affairs.¹²⁴

A corporate insider breaches a fiduciary duty by trading on inside information to make a profit or to avoid losses. Where a director or employee for that matter has breached his fiduciary duty by using confidential information he is liable to account for the profits made. It is immaterial whether the company actually suffered damage or not or could possibly have been harmed. The company may be entitled to institute legal action against the employee for breach of fiduciary duty or an action in tort for infringement of the company's right to privacy. With respect to insider trading in securities of public listed companies, the state through the regulatory body, the SEC in the case of United States and in South Africa the Financial Services Board, will hold that inside trader accountable for civil and criminal liabilities.

In *re Cady Roberts & Co.*,¹²⁵ an employee of a broking firm who was also a director of publicly held company, learned of the proposed reduction in impending dividends to be paid to shareholders by the company in his capacity as a director. He revealed this information to a partner in the broking firm, who sold shares in the company on account of that information to several clients of the broking firm prior to the public announcement of the reduction in dividends. It was held that the broker violated the insider trading prohibition. The SEC applying the broad construction of the provisions in Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 took the view that the prohibitions of insider trading was founded partly on fiduciary principles, arguing that the relationship between an insider and a company gave him access to confidential information which could be used only for corporate purposes and not for the personal gain of anyone. The other facet of the prohibition the SEC relied on is the

¹²⁴ Eilis Ferran *Company Law and Corporate Finance* (Oxford: Oxford University Press, 1999) 123.

¹²⁵ 40 SEC 907 (1961).

inherent unfairness of the insider trading with information knowing that it is unavailable to those with whom he is dealing.¹²⁶ The Commission said:

[t]he existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by the fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.¹²⁷

The SEC did not put much stock in duties in *Cady* but articulated the rationale of the fiduciary duty. It adopted the disclose or abstain rule, that those in possession of material non-public information must disclose it before trading or abstain from trading until the information is made public. It was held that, since the defendant had obtained the information from a business partner who is an insider, the defendant shared in the insider's abstain or disclose obligation.

In a later case, *SEC v Texas Gulf Sulphur Company*,¹²⁸ a federal circuit endorsed the application of disclose or abstain duty from trading to anyone in possession of material information. The directors and officers of a mining company were held liable for profits they made as a result of trading on undisclosed information as to the discovery of mining deposits.

In 1959 Texas Gulf Sulphur Company exploratory prospecting surveying equipment detected and produced some evidence of existence of valuable deposits of copper, zinc and silver in an area of Ontario, Canada. The first drilling took place in 1963 which confirmed the existence of enormous valuable commercial quantities. Tight control measures were put in place by the company to keep this information confidential and prevent any leakage of information to outsiders. Meanwhile, corporate insiders comprising of various officers, directors and employees exploited the situation bought

¹²⁶ Ibid at 912.

¹²⁷ Ibid

¹²⁸ 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

shares and call options of Texas Gulf Sulphur Company or obtained stock options and tipped other people to purchase stock or options of the company. During this period, the stock prices of the company were relatively low.

Rumours were circulating about the company's discovery of the minerals and the stock price rose from \$17.375 to \$29.375 on November 10, 1963. Eventually, the company made a public announcement of the discovery on April 16, 1964 and the stock price jumped to \$71 on April 19, 1964. Substantial profits were made by those who had purchased the stock or acquired stock options of the company prior to the public announcement. In April 1965, the SEC filed a suit against a number of directors, managers and employees as individual defendants for violating Rule 10b-5 of the Securities Exchange Act of 1934 by purchase and sale of securities on the basis non-public material information, making available such information directly or indirectly to other persons to trade or deal in the securities of Texas Gulf Sulphur Company while the information remains confidential and engaging in other conduct of similar purport and object. The SEC won the case in that the conduct of the defendants was found to impair the integrity of the market which is the target of Rule 10b-5.

The court's approach placed emphasis on access to information, that investors in a market should have an equal opportunity to obtain and evaluate information relevant to trading decisions. In noting the essence of Rule 10b-5 was to ensure that all persons trading on the securities market should have relatively equal access to material information and be subjected to the same market conditions, Judge Waterman stated:

‘Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, he must abstain from trading in recommending the securities concerned while such information is undisclosed.’¹²⁹

Thus, the duty to disclose information, however, seem not to be an absolute one, but an alternative one, that of either disclosing or abstaining from trading. The disclosure of material information to the investing public is incumbent on the company and whilst the information remains confidential, an insider must abstain from dealing in it. It will be

¹²⁹ Ibid at 848.

breach of fiduciary duty if the insider discloses corporate confidential information before trading.

The obligation to disclose or abstain from trading as set out in the Supreme Court decision in *Chiarella v United States*,¹³⁰ is based on fiduciary duty. Vincent Chiarella was a worker in a financial printing company who received information by reading printing jobs and figured out the names of the acquisition target firms of the printing company and bought stocks of the target firms prior to public announcements. He was charged by the SEC for committing insider trading offences. The court held that he was not liable for insider trading because he owed no fiduciary duty to those with whom he traded; the acquisition target firms and in the absence of a relationship of trust or confidence, he had not contravened Rule 10b-5.

Chiarella was not found liable for insider trading neither as a primary insider or a secondary insider, commonly referred to as ‘tippee’ (receivers of second-hand information). The majority of the court held that the misappropriation theory was not available to found conviction in the case as it was not properly presented to the jury.¹³¹ The U.S. Supreme Court *in casu* left open whether Rule 10b-5 would be contravened where an insider who misappropriated and traded on information obtained from another if the insider was not under fiduciary obligation either to the issuer of the securities or to the other party to the trade. However, subsequent cases by appeal courts there under have adopted the misappropriation theory. The theory encompasses and extends the fiduciary duty to the extent that the owner of the information may not necessarily be the issuer of the securities.

The policy underlying the fiduciary duty obligation is to prevent any temptation which the fiduciary may succumb to when faced with the opportunity of preferring his own interests over and above those of the company or beneficiary. They are also intended to protect the institution of agency, integrity of commercial organizations and public interest or the society at large. Fiduciary duties are made absolute and strictly applied by the courts irrespective of whether the company or beneficiary suffered a loss or not.

¹³⁰ 445 U.S. 222 (1980).

¹³¹ *Ibid* at 236

‘Statutory definitions of what constitutes an “insider” for the purposes of insider trading laws may be based on either a “person connection” approach or an “information connection” approach. The “person connection” approach defines “insider” by reference to the relationship of the person to the public issuer of securities, while the “information connection” approach considers anyone who has material price-sensitive information about the issuer to be an insider, regardless of his or her relationship to the issuer.’¹³² In some jurisdictions such as Japan, Hong Kong and China, insider trading law uses a person connection approach in its definition of insider whilst others such as Australia have to a varying degree amended their definitions of insider to reflect the information connection approach.¹³³ ‘United States, although the first country to address the issue of insider trading, lacks a statutory definition of “insider” and instead relies on generally applicable laws against securities fraud. It has developed a definition with elements of both approaches.’¹³⁴

With regards to insider trading legislation, explanations based on the fiduciary duty theory, in a narrow context restricts the scope of the duty to corporate insiders which requires a person to have a relationship with the issuer of the securities or the company that holds the information. Thus, the duty is given a person connection to corporation approach in order for someone to be considered as an insider. It is argued that the insiders are agents of the corporation engaging in a prohibited insider trades obtain their information via fiduciary relationships, and trading on this information for personal gain is a breach of that duty.¹³⁵

When dealing with the principal the agent is required to disclose all material facts. It would be unfair for the agent to profit by dealing with an uninformed principal as the agent is already compensated. It is argued by regulators that the insiders acquired the information in their capacity as fiduciaries of the shareholders, and thus may not use it in dealings with the shareholders.¹³⁶ ‘If insider trading is permitted, the shareholders will

¹³² Z Su and MA Berkahn ‘The definition of “Insider” in Section 3 of the Securities Markets Act 1988: A Review and Comparison with other Jurisdictions’ (November 2003). *Massey University, School of Accountancy, Discussion Paper Series No. 218*

Available at <http://www-accountancy.massey.ac.nz/Publications.htm> (accessed 5 December 2006)

¹³³ Ibid

¹³⁴ Ibid

¹³⁵ Hu and Noe (note 82) at 39.

¹³⁶ Ibid

either demand a premium to compensate for the risks imposed or will expend resources policing management.’¹³⁷ Therefore, prohibiting insider trading prevents a costly breach of fiduciary duty. It is to be noted that whatever distinctions that existed based on the common law view that an officer or director stand in a fiduciary relationship only to existing shareholders from whom he purchases securities but not to the investors to whom he deals, is not appropriate in the securities market.

In *Chiarella v United States*,¹³⁸ the court held the trader’s fiduciary duty was the basis of his violation of the insider trading prohibition and this was reaffirmed in *Dirks v SEC*.¹³⁹ Dirks was a securities analyst and received inside information from employees of a company that the company was engaged in a massive fraud. He acted on this information by alerting his clients to sell their securities in the company. The employees acted not for personal gain but with the intent to expose fraud. The US Supreme Court held that corporate insiders owed fiduciary duty to shareholders and must either disclose material inside information or not to trade in the securities of the company.¹⁴⁰ The Court further held that a tippee, who receives material non-public information from an insider and trades on it violates Rule 10b-5 and is liable if he knew or had reason to believe that the insider had breached a fiduciary duty in disclosing the confidential information. Dirks was not held liable for trading on inside information because the disclosure of the information was for the purpose of exposing fraud and not for personal gain. His tippee also escaped liability and nobody was liable for insider trading violation as the disclosures of the information was to expose fraud.

The decision in *Dirks* was quite significant regarding analyst liability for insider trading, tippees liability and the development of the concept of “constructive insiders.” The decision in the case suggests that a primary insider violates his fiduciary duty or Rule 10b-5 only if he is seeking personal benefit. Under US law a primary insider are directors, corporate officers and controlling shareholders. “Temporary” or “constructive insiders” are outsiders who legitimately receive confidential information from a

¹³⁷ Ibid

¹³⁸ 445 US 222 (1980). See below for detailed discussion of the case.

¹³⁹ 463 US 646 (1983).

¹⁴⁰ 463 US 646, 653 (1983).

corporation in the course of providing services to the corporation such as lawyers, consultants, accountants and investment bankers.¹⁴¹

Constructive insiders may become privy to inside information and acquire fiduciary duties provided the corporation expected the constructive insider to keep the information confidential.¹⁴² Thus, constructive insiders become liable since they acquire the fiduciary duties of a true insider. Under normal circumstances financial analysts are not considered as temporary insiders since they are receivers of secondary information. As a result they come within the definition of secondary insiders under US law.¹⁴³ The secondary insider becomes liable for breaching fiduciary duty only if he knows or has reason to believe that the primary insider is breaching a duty by providing the information.

In practice the “personal benefit” standard of liability espoused in *Dirks* has proved confusing and difficult to apply.¹⁴⁴ The SEC and the courts seemed to have taken an expansive view of the personal benefit test to impose a fiduciary duty. It has been argued that corporate insiders have been found to be in breach of their duties by seeking intangible, reputation benefits or making gifts of confidential information.¹⁴⁵

The fiduciary duty theory has limitations and has been regarded by some commentators as not providing adequate justification for some aspects of insider trading law violations. ‘It does not cover persons who are privy to similar valuable information, as those in the traditional fiduciary relationship, but who have other relationships with the company.’ It is argued that if insider trading is based on breach of fiduciary duty which is private as between employer and employee, then it could be modified by parties to the relationship to exclude the duty and permit insider trading. Such a privatised arrangement of insider trading will have a negative impact on maintaining the integrity of fair and efficient capital markets.¹⁴⁶ However, in most jurisdictions, legislation prohibiting insider trading makes the fiduciary duty rationale mandatory. Imposition of fiduciary theory is

¹⁴¹ Newkirk and Robertson (note 80) at 6.

¹⁴² Ibid

¹⁴³ Caccese (note 77) at 10.

¹⁴⁴ Ibid

¹⁴⁵ Ibid

¹⁴⁶ JD Cox et al *Securities Regulation: Cases and Materials* 3ed (Gaithersburg, New York: Aspen Law & Business 2001) at 966-7.

necessary to ensure that insiders do not abuse their position of trust for personal enrichment.

3.3 MISAPPROPRIATION THEORY

Information is a property that can be owned and traded. A company's confidential information is its property and has an exclusive right of its use. If the information is "misappropriated" (or stolen) by someone else then it is tantamount to fraud akin to embezzlement. The misappropriation theory depicts that it is wrong for someone else to use non-public price-sensitive information other than the owner. '[A]n insider who takes confidential inside company information and uses it to enrich himself is in effect a thief stealing what is not his. Like any common thief who violates the moral rights of those from whom he steals, the insider trader is violating the moral rights of all shareholders, especially those who unwittingly sell him their stock.'¹⁴⁷ The liability of the insider under the misappropriation theory is premised on the notion that a person entrusted with non-public information breaches a fiduciary duty owed to the issuer or someone other than the issuer who gave the information to him to be held in confidence.¹⁴⁸

According to the misappropriation theory a person commits a fraud in connection with a securities transaction when he conducts such a transaction using confidential information which hasn't been made public by the issuer or without its prior approval. Such transactions violate section 10(b) of the U.S. Securities Exchange Act of 1934 and SEC Rule 10b-5. Under U.S law, the courts recognize that a corporation's information is its property.¹⁴⁹

'The misappropriation theory is followed by several lower courts in the United States, including the influential Second Circuit Court of Appeals which sits in New York.'¹⁵⁰ The theory is difficult to apply and has led to conflict among courts in its application. Consequently, insider trading liability may vary throughout the United States. The misappropriation theory has been rejected by the Fourth Circuit Court of Appeals and

¹⁴⁷ Velasquez (note 72) at 455.

¹⁴⁸ Caccese (note 77) at 10.

¹⁴⁹ Ibid

¹⁵⁰ Ibid

the Eighth Circuit Court of Appeals the conflict in application has led to a consideration by the U.S. Supreme Court.¹⁵¹

Prior to the passage of the Securities Exchange Act of 1934 by Congress, the courts sporadically applied the common law tort of fraud to deal with securities transactions.¹⁵² Under the common law, fraud is committed when there is a false representation of material fact by means of a statement or conduct made knowingly or recklessly in order to gain a material advantage on which the claimant relies to his detriment.

Early court decisions under the 1934 Act applied its restrictions broadly and liability by misrepresentation was imputed liberally. The courts emphasized fairness and market integrity over the technical requirements of fraud in the 1934 Act and Rule 10b-5.

In *United States v Carpenter*¹⁵³ the U.S. Supreme Court in upholding insider trading conviction handed down by the Second Circuit Court of Appeals, the justices were evenly split four to four (4 – 4) in its consideration over the validity of the misappropriation theory. The defendant had received his information from a journalist rather than from the company. Had he obtained it from the company it would have been a breach of fiduciary duty he owed to his company by misappropriating confidential information for his personal gain without the owner's permission. The misappropriation theory on the other hand has been used to cover a wider scope to include information misappropriation by other means such theft to protect persons who trade in shares, thereby bringing his act within the misappropriation theory prohibition.

The U.S. Supreme Court adopted the misappropriation theory of insider trading in *United States v O'Hagan*.¹⁵⁴ The O'Hagan case grew out of Grand Metropolitan PLC's (Grand Met) takeover of Pillsbury Company. O'Hagan was a partner in a law firm representing Grand Met. He was not one of the lawyers in the firm acting for Grand Met in this particular deal and after learning of the impending takeover bid used this inside

¹⁵¹ Ibid. (See *United States v O'Hagan*, 512 U.S. 642 (1997), approving the theory, discussed below).

¹⁵² SR Salbu 'The Misappropriation Theory of Insider Trading: a Legal, Economic, and Ethical Analysis' (1992) 15 (1) *Harvard Journal of Law & Public Policy* 223 at 223.

¹⁵³ 791 F 2d 1024 (1986), affd 108 S CT 316 (1987).

¹⁵⁴ 117 S. Ct. 2199 (1997).

information to purchase call options on Pillsbury stock. He exercised his options resulting in profits of over \$4 million when Grand Met publicly announced its tender offer. The SEC prosecuted O'Hagan with insider trading based on the misappropriation theory, arguing that he owed fiduciary duty to Pillsbury for using deceitful acquisition and misuse of information that properly belongs to it. He was convicted on fifty-seven counts of securities fraud, mail fraud and money laundering. The SEC ordered O'Hagan to disgorge his profits. On appeal, a federal appeals court rejected the misappropriation theory but when the case went before the Supreme Court, his conviction was upheld and the ruling was 6-3 in favour of the SEC.

O'Hagan claimed that neither he nor his company owed a fiduciary duty to Pillsbury, so that he did not commit fraud by purchasing Pillsbury options. O'Hagan's arguments were rejected by the court and upheld the conviction. The Court recognized that a corporation's information is its property and that a person commits fraud in connection with a securities transaction when he uses confidential information by breaching a duty arising out of a relationship of trust and confidence regardless of the source of the information. In upholding the conviction, the court said:

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.¹⁵⁵

The misappropriation theory has its shortcomings which limits or overstretches its application. The theory presupposes that insider trading may always be regarded as breach of fiduciary duty or possibly the insider has stolen proprietary information.

'The misappropriation theory inadequately serves the economic function of Rule 10b-5: the maintenance of market integrity. In limiting its restriction to trades made on misappropriated non-public information, the theory prohibits only one category of

¹⁵⁵ 117 S. Ct. 2199 (1997) at 2207.

imbalanced market transactions. Transactions in which parties have disparate access to information that has been legitimately obtained by the advantaged party are permitted under the theory. Economic theory suggests that this disparity itself is inefficient and may result in market failures. In particular, misappropriation theory cannot insure market integrity because the focus on particular transactions fails to address the issue of information asymmetry.¹⁵⁶

Furthermore, under the misappropriation theory, it would seem misappropriation is present only when there is a secretive use of information and there will be no breach if the user discloses his intent to trade in advance to the owner or source of information. It also suggests that if the owner approves the use of the information then the insider could trade with an uninformed party without any constraints, implying that employers and other sources can presumably authorise insider trading if they so desire.¹⁵⁷

Despite its limitations, ‘the misappropriation theory has become one of the most effective tools in the enforcement of the insider law. In one sense, anyone who trades on non-public information could be caught by the misappropriation theory. After all, every insider trading case involves an unauthorised use of information. That is, misappropriation could occur in all insider trading cases, whether the defendant is the classic insider that is embraced in *Chiarella*, or the outsider whose fiduciary relationship with one company provides valuable information about a company with whom the defendant has no relationship.’¹⁵⁸

3.4 MARKET FAIRNESS

It has been suggested that for securities markets to function properly, it is essential that all participants should have relatively equal access to information and those who occupy strategic positions in the market mechanism should be prevented from reaping benefits from information received by virtue of their position as it gives them an unfair advantage over persons with whom they deal.¹⁵⁹

¹⁵⁶ Salbu (note 152) at 233.

¹⁵⁷ Su and Berkahn (note 132) at 7.

¹⁵⁸ Ibid

¹⁵⁹ Bergmans (note 25) at 12.

The concept of fairness is subjective and commentators cannot agree on what the term really means.¹⁶⁰ Easterbrook treats fiduciary duty as separate from the fairness argument.¹⁶¹ Bainbridge merges the concept of fiduciary duty and fairness in his analysis of the fairness argument.¹⁶² 'Fairness can be defined in three principal ways: fairness requires that no trader breach fiduciary duty by trading; fairness requires that no trader possess an informational advantage; and, fairness requires that the trader not harm those with whom he trades.'¹⁶³ Moore points out that the key feature of the fairness arguments is the disparity of information between two parties to a transaction and that trading should be on a level playing field.¹⁶⁴

Where there is disparity of information the field tilts towards one player and away from the other thereby making the transaction to be unfair. Insiders have informational advantage whereas other investors to the transaction lack such information and thus are at a disadvantage. She makes the argument that in general fairness only becomes an issue when one party owes a duty to disclose information to the other party with whom he is trading.¹⁶⁵ Where a duty of disclosure of information is owed it suggests that trading on inside information is sleazy not because it violates the notion of fairness, but because of the breach of fiduciary duty involved. It therefore makes the effectiveness of the fairness argument against insider trading inconclusive and independent of the fiduciary duty concept. Mitchell contends that fairness is not always a reliable principle on which to base a legal intervention, since the absence of implied fair dealing in contractual obligations means that to impose it necessitates the construction of a fiduciary relationship between the insider and his victim or the company whose shares he has dealt in.¹⁶⁶

The market fairness argument is based on the proposition that all investors in the market should have equal access to information from an issuer of securities to enable them to evaluate information relevant to their trading decisions. An insider may obtain access to

¹⁶⁰ Yulong Ma and Huey-Lian Sun, 'Where Should the Line Be Drawn on Insider Trading Ethics?' (1998) 17 *Journal of Business Ethics* 67 at 70.

¹⁶¹ FH Easterbrook 'Insider trading, Secret Agents, Evidentiary Privileges, and the Production of Information' 1981 *Supreme Court Review* 309 at 317.

¹⁶² Bainbridge (note 59) at 55-61.

¹⁶³ Ibid.

¹⁶⁴ Moore (note 7) at 172.

¹⁶⁵ Ibid

¹⁶⁶ PLR Mitchell *Insider Dealing and Directors' Duties* 2ed (London: Butterworths, 1989) 21.

price-sensitive information as a result of his or her relationship with the issuer of the securities or a prospective bidder for those securities; or by receiving the information from a person who has such a relationship.¹⁶⁷ It is argued that insiders have informational advantage by virtue of their position and to permit insider trading is unfair or unjust.¹⁶⁸

Unlike the information advantage of stock experts or analysts, the information advantage of the insider is unfair because it is unjustly stolen from the shareholders who made the investments that ultimately produced the information he stole.¹⁶⁹ Securities analysts own the information he uses because it was produced through his own labour, resources or expenditure in searching to obtain that information. The insider on the other hand, his information advantage comes from stealing the fruits of someone else's labour or resources.

'If a securities market is to be efficient, it must be properly equipped to ensure that the price of securities accurately reflects their value. It might be thought that part of that should include the means of preventing or at least, of discouraging persons who are 'in the know' with unpublished price-sensitive information from taking unfair advantage of their informed position. A "level playing-field" should be preserved, whereby information is promptly "made public" and "insiders" are deterred from abusing their position, if a modern securities market is to preserve credibility. If that is achieved, all investors are then able to deal on the market on equal footing. Everyone has equal access to all material information. This is the 'ideal' position in what has sometimes been described by economists as the theory of market egalitarianism.'¹⁷⁰

Without doubt all investors trading on capital markets face some kind of a risk such as market volatility or unexpectedly variable share prices and the possibility of a market crash. The risk taken by the investors may be such that prices move against them when they deal. Some market participants are more equipped or have better resources or expertise in the gathering of information and ability to interpret the information. Hence

¹⁶⁷ WJ Carney 'Signalling and Causation in Insider Trading' (1987) 36 *Catholic UL Rev* 863 at 863.

¹⁶⁸ Velasquez (note 72) at 455.

¹⁶⁹ Ibid

¹⁷⁰ Brazier (note 42) at 83.

there will always be some investors with informational advantage over others and market egalitarianism cannot be achieved.

The market fairness approach as the basis of insider trading prohibition fails to address the advantage of superior skills or expertise of analyst, time, resources or commitment that some investors may have over others in accessing information on the market thereby resulting in being informationally advantaged.

Market fairness arguments emphasize disclosure and widespread dissemination of information on the market to ensure that all market participants have equal access to the relevant information. Regulators argue that prohibition of insider trading removes information asymmetry in the securities market. However, inequalities in access to information may exist because of inequalities in education and resources. Having better resources and expertise improves one's competitiveness in the market. The market fairness theory is not concerned with the superior advantage one investor may have over another investor. Instead it targets the insider and prevents him from using his informational advantage over other investors or market participants and this is desirable for the securities market.

Arguments for the deregulation of insider trading are unconvincing. Permitting insider trading with the view to compensate the agents for innovation and entrepreneurship will lead to conflict of interest. Insiders will look after their interest at the expense of the shareholders. Investors have reasonable expectation for rise in the value of their investment and economic growth. Insiders can use inside information to manipulate the securities market, making it inefficient and damage investor confidence in the market.

CHAPTER 4

INSIDER TRADING: A SOUTH AFRICAN PERSPECTIVE

Insider trading occurs when there is dealing in securities or financial instruments by a person knowingly in possession of inside information, relating to the instrument being dealt in.¹⁷¹ Being subversive of the efficient functioning of and undermines investor confidence in financial markets, it is outlawed internationally.¹⁷² Variations exist in the legislation enacted by various countries to prohibit insider trading. This chapter examines the insider trading regulation in South Africa. The current legislation prohibiting insider trading is contained in chapter VIII of the Securities Services Act 36 of 2004 (the Act) which came into effect on February 1, 2005. The Financial Services Board (FSB) is the regulatory body appointed to oversee the regulation of insider trading with the aid of the courts. In addition the JSE Securities Exchange (JSE) and the Securities Regulation Panel (SRP) play an important role in regulating insider trading in South Africa. The JSE regulates insider trading through its Listing Requirements and in the case of the SRP through its Code on Mergers and Takeovers.

4.1 WHAT IS INSIDE INFORMATION?

Inside information is defined in Section 72 of the Act as:

- ‘.....specific or precise information, which has not been made public and which—
- (a) is obtained or learned as an insider; and
 - (b) if it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market.

For a person to be caught by the insider trading prohibition, the following elements of the inside information definition is significant:

- specific or precise information;

¹⁷¹ Tshepo Mongalo et al (note 6) at 290.

¹⁷² Ibid at 292.

- the information has not been made public;
- the information is obtained or learned as an insider; and
- if it were made public it would be likely to have **material effect** on the price or value of any security on **a regulated market**.

A brief overview of these elements is given below.

Specific or precise information

The specific or precise requirement is the same as the UK legislation on insider dealing which is modelled on the EU Directive on Insider Dealing.¹⁷³ Maug contends that the EU legislation requiring inside information to be precise is a narrow definition that creates a grey zone, whereby information is private but cannot be classified as inside information.¹⁷⁴

The focus on specific or precise requirement is absent in the insider trading legislation of Australia, Corporations Act, 2001. Information is broadly defined to include matters of supposition and other matters that are insufficiently definite to warrant being made known to the public; and matters relating to the intentions or likely intentions of a person.¹⁷⁵ It is an inclusive definition rather than exhaustive and cast the net wider than the South African legislation. It has been argued that the specificity or precision requirement removes vagueness and serves to assure market participants that transactions based on rumours, suspicion, conjecture, speculation, or a combination thereof, do not fall within the prohibition.¹⁷⁶ However, it is possible information can be specific but may be vague or remain imprecise, as for example where an insider having a specific knowledge of an imminent issue of rights offer but not knowing the exact details of the issue.

¹⁷³ Sections 56 and 60(4) of the Criminal Justice Act 1993 of the UK states what constitutes inside information and is based on the EU Directive on Insider Dealing (Dir 89/592[1989] OJ L334/30).

¹⁷⁴ EG Maug 'Insider Trading Legislation and Corporate Governance' (March 25, 1999) EFA 0664. Available at <http://ssrn.com/abstract=157598> (accessed 30 December 2006).

¹⁷⁵ Corporations Act, 2001, s1042A(1).

¹⁷⁶ PC Osode 'The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill?' (2000) 44 (2) *Journal of African Law* 239 at 243.

‘The Act does not define what constitutes specific or precise information and the courts will determine this on a case-by-case basis. What may constitute specific or precise information in one situation may possibly not do so in another, depending on the surrounding circumstances.’¹⁷⁷

Information has not been made public

In order to be liable for insider trading offence, the information must not have been made public prior to dealing in securities. This requirement for putting information in the public domain before dealing is to ensure that all market participants have equal access to relevant information. Section 74 of the Act gives guidance on ascertaining whether the information is public. It provides that:

- ‘(1) For the purposes of the definition of “inside information”, information is regarded as having been made public in circumstances which include, but are not limited to, the following:
 - (a) When the information is published in accordance with the rules of the relevant regulated market for the purpose of informing clients and their professional advisers;
 - (b) when the information is contained in records which by virtue of any enactment are open to inspection by the public; or
 - (c) when the information can be readily acquired by those likely to deal in any listed securities—
 - (i) to which the information relates; or
 - (ii) of an issuer to which the information relates; or
 - (d) when the information is derived from information which has been made public.
- (2) Inside information which would otherwise be regarded as having been made public must still be so regarded even though—
 - (a) it can be acquired only by persons exercising diligence or observation, or having expertise;
 - (b) it is communicated only on payment of a fee; or
 - (c) it is only published outside the Republic.’

The scope of determining whether information has been made public is wide and non-exhaustive as these are not the only circumstances in which information would be regarded as being in the public arena. The discretion which the regulators had in the second limb of the definition in the Insider Trading Act has been made mandatory.

¹⁷⁷ See *Insider Trading and Other Market Abuses (Including the Effective Management of Price Sensitive Information)*. JSE booklet (November 2006) at 6
Available at <ftp://ftp.fsb.co.za/public/insider/JSEbooklet.pdf> (accessed 14 December 2006)

Inside information *may be* regarded as having been made public in that Act (s 3(2)), is now *must still be* regarded as having been made public (s 74 (2)). Although the definition takes care of analyst use of research reports, information obtained from foreign markets and obscured sources, the inside information definition is incongruous as it does not explicitly delineate information which has not been made public. This makes the issue of information having been made public contentious and would make it more difficult to obtain evidence for effective prosecution and conviction of insider trading cases.

The information is obtained or learned as an insider

Luiz observed in the Insider Trading Act that the criterion that the information is obtained or learned as an insider is dealt with in a circular manner.¹⁷⁸ For an information to be considered as *inside information* it must have been obtained as an *insider* a term which in turn is defined in section 72 of the Act as *person* who has *inside information*.¹⁷⁹ ‘Thus if a person does not obtain information or learn it as an insider, then such person would not be regarded, for the purposes of the Act, as trading by virtue of inside information. However, it is important to realise that the definition of an insider is very broad and it can encompass even someone who is not connected with the concerned company, ie a tippee.’¹⁸⁰ The definition of an insider is discussed in 3.2 below.

The information if it were made public it would be likely to have material effect on the price or value of any security on a regulated market

Materiality is evaluated against price movement but the Act does not define material effect or provide any list of events which will make it material. This gives room for the regulator or courts to determine what information could influence price or value of securities with changing circumstances. However, an insider with informational advantage acquisition or disposal of securities that will not cause price movement of the value of securities would seem to fall outside the prohibition. ‘Thus the information that would not have a material effect on the price or value of securities is excluded from the

¹⁷⁸ SM Luiz ‘Insider Trading Regulation — If at First You Don’t Succeed....’ (1999) 11 SA Merc LJ 136 at 141.

¹⁷⁹ Ibid

¹⁸⁰ Mongalo et al (note 6) at 296.

prohibition. If the information will only lead to a slight increase in the value of securities and such increase will be immaterial then such information is excluded.’¹⁸¹

In the UK materiality of information determination like South Africa is based on price-sensitivity. Although, under United States jurisdiction, information is material for the purposes of insider trading if it is such that someone in possession of inside information could be expected to succeed to trade in the particular securities to make a profit or avoid losses, for practical purposes, price sensitivity is a key concern as well, since insider trading prosecutions are generally only brought where there is a movement in stock prices after the information became public.¹⁸² In Malaysia, insider trading regulations in Division 2 of the Securities Industry Act 1983 and provisions in sections 132A & B of the Companies Act 1965, provide a catalogue of events for which information can always be regarded as material. Such an approach produces certainty. However, the impact of a specific event may not produce the same result of price movement on the value of securities at different times and surrounding circumstances.

4.2 WHO IS AN INSIDER?

The definition of an insider in section 72 of the Act:

“insider” means a person who has inside information—

- (a) through—
 - (i) being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or
 - (ii) having access to such information by virtue of employment, office or profession; or
- (b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a).”

As discussed above, there are two approaches to defining who can be regarded as an insider, the ‘person connection’ and ‘information connection’ approaches.¹⁸³ The person connection approach regards a person having information and who has a direct or indirect relationship with the issuer of the securities as an insider and are often regarded as primary insiders. This covers persons in s 72(a) of the Act, including natural persons

¹⁸¹ Ibid

¹⁸² Mark Stamp and Carson Welsh (eds) (note 29) at 22-23.

¹⁸³ See text on note 132 above.

in their capacity as directors, shareholders, employees, other officials of the company such as legal advisers who are not employees, brokers, government functionaries, bank managers and juristic persons such as the issuer of the securities itself, companies, a trust and partnerships.

The information connection approach regards any person who has inside information that is price-sensitive which has not been made public to be liable regardless of their relationship to the source of the information or irrespective of how the person learned the information. For example a barman, the taxi driver who overhears directors or other primary insiders discussing non-public price-sensitive information such as a change in earnings or dividends and deals in the securities will be caught by the prohibition.¹⁸⁴

Persons who are associated with the company through being directors, officers, employees or shareholders and those by virtue of their employment, office or profession are regarded as primary insiders (persons in paragraph (a)). Secondary insiders are persons who obtain their inside information directly or indirectly from someone else in paragraph (a). They are sometimes referred to as tippers.

The person connection approach is narrow as it covers only persons with connection with the issuer of the securities. Australian legislation has adopted the broad definition of information connection of an insider.¹⁸⁵ It requires that an insider must possess inside information that is not generally available which the insider knows or ought reasonably to know that the matters it would have material effect on the price or value of securities of a body corporate.¹⁸⁶ It is enough the alleged insider trader possessed the information at the time of trading or procured another person to trade. Su and Berkahn contend that trading with knowledge while in possession of information, rather than a person's connection, is what can detrimentally affect the market.¹⁸⁷ The South African definition of an insider fits with the personal connection approach as the person is expected to know the source of the information.

¹⁸⁴ Richard Jooste 'The Regulation of Insider Trading in South Africa — Another Attempt' (2000) 17 *South African Law Journal* 284 at 288-289.

¹⁸⁵ Section 1043A(1) Australian Corporations Act 2001.

¹⁸⁶ Information is defined in s 1042A of the Corporations Act to include matters of supposition and other matters that are insufficiently definite to warrant being made known to the public.

¹⁸⁷ Su and Berkahn (note 132) at 9.

In some jurisdictions such as the UK, corporate entities are not included in the definition of insiders, however, natural persons who carry on transactions on their behalf to commit insider trading offences are held liable. It seems the intention of parliament to include juristic persons in the definition of insiders is to motivate them to introduce and maintain high standards whilst handling information and dealing for the entity's account. In the repealed section 440(1) of the Companies Act, the offence of insider dealing could be committed by 'any person'. This meant that the crime could be committed by natural and legal persons such as companies. The practical difficulties and the effectiveness of the Chinese Wall defences made the King's Task Group to recommend its repeal in its final draft report on insider trading.¹⁸⁸

4.3 INSIDER TRADING OFFENCES AND DEFENCES

The offences prohibited by the Act are the same as those contained in section 2 of its predecessor, the Insider Trading Act 135 of 1998. Section 73 of the Act specifies what constitutes insider trading offences and the available defences. Four types of conduct of a person using inside information are prohibited by the section, namely, dealing for one's own account, dealing for any other person, improper disclosure of information and encouraging or discouraging another person dealing based on the inside information. Some of the defences which were available to accuse in section 4 of the Insider Trading Act have been dropped from the Securities Services Act. The defence that the offender would have acted in the same manner even without the inside information has been removed. Also the defence that if the insider who disclosed inside information is able to prove on balance of probabilities that he or she believed on reasonable grounds, that no person will deal in the securities or financial instrument as result of such disclosure has been dropped.

4.3.1 Dealing for one's own account

Section 73(1)(a) prohibits an insider dealing for his or her own account. It states:

‘An insider who knows that he or she has inside information and who deals directly or indirectly or through an agent for his or her own account in securities listed on a regulated

¹⁸⁸ See paragraph 3.1.2 of the King's Task Group Report and 2.3 of this paper.

market to which the inside information relates or which are likely to be affected by it commits an offence.’

Section 73(1)(b) sets out the defences to paragraph (a) that:

‘An insider is, despite paragraph (a), not guilty of any offence contemplated in that paragraph if such insider proves on a balance of probabilities that he or she—

- (i) was acting in pursuit of the completion of an affected transaction as defined in section 440A of the Companies Act;
- (ii) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider.’

4.3.2 Dealing for another person

Section 73(2)(a) prohibits an insider dealing for any other person. It provides that:

‘An insider who knows that he or has an inside information and who deals, directly or indirectly, for any other person in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.’

Section 73(2)(b) outlines the defences to paragraph (a) that:

‘An insider is, despite paragraph (a), not guilty of any offence contemplated in that paragraph if such insider proves on a balance of probabilities that he or she—

- (i) is an authorised user and was acting on specific instructions from a client, save where the Inside information was disclosed to him or her by that client;
- (ii) was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, the management of public debt or external reserves; or
- (iii) was acting in pursuit of the completion of an affected transaction as defined in section 440A of the Companies Act;
- (iv) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider.’

Consequently, ‘institutions that have been named “market makers” in the bond market by the South African Reserve Bank may not be deemed as carrying on insider trading if

they are acting under specific instructions from the central bank to deal in bonds.’¹⁸⁹

4.3.3 Improper Disclosure of inside information

Section 73(3)(a) prohibits improper disclosure of inside information to another person. It states:

‘An insider who knows that he or she has inside information and who discloses the inside information to another person commits an offence.’

This provision makes the person in possession of information (Mr. Dee) which he has knowledge that it is an inside information and discloses it to another person, for example to his wife (Mary) to be caught by the prohibition. Mr. Dee then commits the insider trading offence by communicating the information. Mary on the other hand will not be guilty of the offence unless she deals in securities with the information received or discloses it to a third person or encourages or discourages another person from dealing.

Section 73(3)(b) sets out the defences an accused may use for the offence in paragraph (a). It states:

‘An insider is, despite paragraph (a), not guilty of the offence contemplated in that paragraph if such insider proves on balance of probabilities that he or she disclosed the inside information because it was necessary to do so for the purpose of the proper performance of the functions of his or her employment, office or profession in circumstances unrelated to dealing in any security listed on a regulated market and that he or she at the same time disclosed that the information was inside information.’

In this respect, if a director seeking a legal advice on behalf of the company discloses inside information to an attorney in the course of performance of his/her duties will not be contravening the offence in section 73(3)(a).

4.3.4 An Insider encouraging or discouraging dealing by another person.

Section 73(4) of the Act prohibits the conduct of an insider encouraging or discouraging

¹⁸⁹ See *Insider Trading and Other Market Abuses (Including the Effective Management of Price Sensitive Information)*. JSE booklet (November 2006) at 18
Available at: <ftp://ftp.fsb.co.za/public/insider/JSEbooklet.pdf> (accessed 14 December 2006).

another person dealing in securities. There are no defences specifically stipulated to deal with this prohibition. In terms of section 73(4):

‘An insider who knows that he or she has inside information and who encourages or causes another person to deal or discourages or stops another person from dealing in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.’

An insider may encourage or discourage a person to deal or not deal in a specified securities without disclosing the inside information. The insider by so doing contravenes the provisions of the section and guilty of the offence. If the person encouraged or discouraged merely acts on the advice given to him to deal or abstains from dealing without receiving the inside information, then he is not guilty of the offence.

4.4 CRIMINAL LIABILITY

As discussed above, a person commits a criminal offence by contravening the provisions of section 73 of the Act. Section 115 sets out the stiff penalties which could be imposed upon successful prosecution and conviction of an accused. A fine not exceeding R50 million or imprisonment for a period not exceeding 10 years, or to both such fine and imprisonment may be imposed. However, the provisions of section 80(1) require the court to take into account when imposing criminal sanctions any award previously made for civil remedies under section 77 arising out of the same cause.

4.5 CIVIL LIABILITY

In addition to the criminal sanctions, the Act makes provision for imposition of civil liabilities in the form of monetary sanctions on an offender. Section 77 deals with civil liability resulting from insider trading. Unlike the criminal sanctions where the prosecution has to prove beyond reasonable doubt, the civil penalty requires only the lower burden of proof, on a balance of probabilities, to be made against the offender by the regulator (FSB).

In terms of section 77 of the Act, the FSB has been granted more powers to institute civil action against an insider who contravenes the provisions of section 73, if it considers that it is in the public interest to do so to obtain the following remedies:

- recover the profit made or the loss avoided, whether realised or not;
- award a penalty of an amount up to three times such profit or loss avoided;
- recoup its legal and investigation costs from amounts recovered and distribute the balance to compensate investors who can proof that they transacted in the relevant securities and suffered loss as a result of the illegal dealings by the insider at any time between the insider trading and the time when the inside information became public; and
- may also respond positively to an offer of settlement from parties under investigation for insider trading.

4.6 ENFORCEMENT

The FSB is empowered by the Act as the regulatory body to oversee insider trading regulation in South Africa.¹⁹⁰ It is the equivalent of the SEC in the United States jurisdiction. The Act established the Directorate of Market Abuse (DMA) to replace Insider Trading Directorate (ITD) of the Insider Trading Act 135 of 1998.¹⁹¹

The ITD was mandated to conduct investigations and institute civil legal action against insider trading offenders. These functions are now carried out by the DMA. It should be pointed out that the scope of the mandate of the DMA is wider than that of the ITD as the DMA deals with all forms of market abuse in addition to insider trading cases. Upon investigations, the DMA if appropriate, may institute a derivative civil action and / or forward its report to the newly created Enforcement Committee of the FSB for it to be dealt with in accordance with section 102 to 105.¹⁹² Enforcement procedures are contained in Chapter IX of the Act. The Enforcement Committee has the mandate to impose administrative penalties and compensatory amounts on offenders in sections 104 and 105 respectively.

¹⁹⁰ Section 82(1).

¹⁹¹ Section 83(1).

¹⁹² Section 94(e).

The right of appeal by an aggrieved person to the decision of a board committee to the board and review of a decision of the board itself in a competent court of law is provided for in section 111 of the Act.

In terms of section 85 of the Act, the common law rights of any aggrieved person resulting from a transaction by another person in contravention of the insider trading prohibition is protected. The aggrieved person may institute a legal action in his own right against the offender to recover his loss. However, any amount awarded to him by the court will be deducted from claims amount to be received from the FSB.¹⁹³

The common law principles of vicarious liability are applicable to the civil liability of insider trading.¹⁹⁴ 'It is unclear to what extent employers are exposed to vicarious liability in the insider dealing context. In terms of the general principles governing vicarious liability the employer can escape such liability if the employee has (1) subjectively viewed, promoted only his own interests, and (2) objectively viewed, entirely disengaged himself from his contractual duties.'¹⁹⁵

Criminal prosecutions are the responsibility of the Directorate of Public Prosecutions and are its prerogative to act on insider trading cases referred to it by the FSB.

From the South African perspective, insider trading is an affront to the integrity and proper functioning of financial markets and the legislature has made concerted efforts to regulate and eradicate the practice.¹⁹⁶ This rationale for regulating insider trading fits in with the market efficiency and market fairness arguments for the prohibition of insider trading as they focus on the impact of using inside information on the market. The Act makes insider trading a criminal offence and provision is made for offenders to incur civil liability or both. Previous attempts regulating insider trading yielded no success in the prosecution of offenders. This seems to legitimize proponents of insider trading argument that insider trading laws are ineffective and difficult to enforce. However, the

¹⁹³ Section 77(10).

¹⁹⁴ Section 77(11).

¹⁹⁵ Jooste (note 185) at 303.

¹⁹⁶ Insider trading regulation is part of the wider regulation of the South African financial markets which aims *inter alia* at increasing confidence in the markets by provision of securities service in a fair, efficient and transparent manner and promoting international competitiveness of the markets (Section 2).

civil remedies component of the Act and its predecessor has culminated in recovery of profits and penalties from offenders, implying that enforcement of insider trading laws work.¹⁹⁷ It remains to be seen how successful the Act will be in terms of successful prosecutions of offenders. Flaws in the Act should be amended to improve its effectiveness.

¹⁹⁷ See 4.2 below.

CHAPTER 5

THE EFFECTIVENESS OF INSIDER TRADING REGULATIONS

There is a consensus achieved among governments around the world that insider trading laws are good for the society and firms as well consider insider trading undesirable and therefore they have implemented policies in restricting insider trading.¹⁹⁸ 'Every developed country today has these insider trading laws, and four out of five emerging market economies have it.'¹⁹⁹ Insider trading laws of most countries are designed to preserve the integrity of fair and efficient capital markets in order to promote investor confidence in the markets. This is evident in section 2 of aims of the Securities Services Act which embodies insider trading regulation in South Africa. Included in the aims of the Act are the three objectives of good securities market regulation recommended in the 'Objectives and Principles of Securities Regulation' published by the International Organization of Securities Commissions (IOSCO) in 1998 and updated in March 2003: (i) investor protection (ii) ensuring that markets are fair, efficient and transparent, and (iii) reducing systemic risks.²⁰⁰ The legislation against insider trading and regulatory mechanisms is regarded to be effective if it is capable of eradicating the practice or reducing its incidence. This chapter examines the effectiveness of insider trading legislations and the extent to which the regulators are able to maintain a fair, honest and efficient capital markets.

5.1 CONSTRAINTS IN THE REGULATORY ENVIRONMENT

Regulatory bodies encounter serious problems in policy implementation to protect investors and issuers of securities. Shin asserts that the constraint in achieving the objective of the regulatory policy is that the insider is not the only trader who trades on information about the firm.²⁰¹ Market professionals who act as agents for investors or as

¹⁹⁸ Utpal Bhattacharya and Hazem Daouk 'The World Price of Insider Trading' (2002) 57 (1) *Journal of Finance* 75 at 90.

¹⁹⁹ Ibid

²⁰⁰ The Principles are discussed in the document: 'Insider Trading - How Jurisdictions Regulate It,' Report of the Emerging Markets Committee of the International Organization of Securities Commissions (March 2003). Available at www.iosco.org (accessed 14 August 2006).

²⁰¹ Jhinyoung Shin 'The Optimal Regulation of Insider Trading' (1996) 5 *Journal of Financial Intermediation* 49 at 67.

part of the market mechanism itself such as investment advisors, securities analyst and brokers create market based information or receive corporate based information because of their special position or function in the market.²⁰² They spend resources to acquire superior information about the firm, but their information-based trading is not subject to the same regulatory restriction and this makes complete ban of insider trading impossible.²⁰³ They can reap the same profits and cause the same problems as traditional corporate insiders by trading on inside information or tipping others. Stricter regulatory policy results in increased profit for market professionals at the expense of liquidity traders thereby defeating the regulator's objective of minimizing trading loss of liquidity traders.²⁰⁴ Caccese argues that the financial analyst plays an important role in the securities markets that needs to be protected from some of the chilling effects that ill-defined or selectively enforced insider trading rules have on the dissemination of information essential for financial analyst to perform their jobs.²⁰⁵

Another problem encountered by the regulatory authority relates to the intangible nature of the good being controlled - information. It is easily communicated to third parties and sometimes unconsciously. 'The regulator faces a "*first accessing person*" problem, that is, there is always a first person who has access to the information. As consequence, even if this person is under great scrutiny, the regulator is confronted with an additional problem. He cannot prevent this person from *communicating* this information to a third party except by prohibiting this person from accessing the information, which is impossible because that would mean prohibiting her from performing her task.'²⁰⁶ More than one person in a corporation may have access to material information who may communicate to third parties, and they in turn may communicate directly or indirectly to others. As the network widens, the information become distorted and becomes difficult for the regulator to trace back to the source. This increases the potential for illegal transactions. For insider trading regulation to be effective, the problem must be attacked at its source, that is, the first individual who has access to inside information.²⁰⁷

²⁰² Bernhard Bergmans (note 25) at 127-8.

²⁰³ Shin (note 201) at 76.

²⁰⁴ Ibid at 68.

²⁰⁵ Caccese (note 77) at 12.

²⁰⁶ Padilla (note 4) at 52.

²⁰⁷ Ibid at 53.

Regulatory authorities such as FSB and the SEC use a multi-pronged strategy to detect and prosecute illegal insider trading including surveillance, tip-off from informants or ex-spouses, tangible evidence such as notes, memoranda or telephone conversations which indicate that an investor traded on the basis of inside information, statistical and other circumstantial evidence.²⁰⁸

The lack of hard evidence due to the intangible nature of inside information and dependence on circumstantial evidence such as unusual price movements on a trading day to detect and prosecute insider trading violations poses problems which undermine the effectiveness of the regulation itself.²⁰⁹ The regulators criterion to trigger an investigation is when the price movement during a trading day exceeds a certain threshold. Insiders with accurate inside information are better placed to predict accurately future securities prices and are also in a position to predict when the regulator is going to suspect that non-public information has been circulated and insider trading has been taking place. Consequently, the insiders will modify and adopt trading strategies to avoid detection by the regulator thereby making insider trading regulation ineffective.²¹⁰

5.2 RECORD OF INSIDER TRADING LAWS ENFORCEMENT.

The theories underlying insider trading regulation and sanctions imposed are applied to varying degrees in different countries. The detection and severity of sanctions handed down to offenders of insider trading serves as the main deterrent against the practice. 'Most countries have rules against insider trading but the temptation for insiders to violate the rules still remains.'²¹¹ Shin argues that it is not the existence of the laws making insider trading illegal that matters but how strictly the law is enforced, which in turn is determined by the regulatory policy.²¹² There has been conflicting findings of various studies on the effectiveness of insider trading laws enforcement.

²⁰⁸ Ibid

²⁰⁹ Ibid at 54.

²¹⁰ Ibid at 56.

²¹¹ Shin note (201) at 50.

²¹² Ibid at 67.

Bettis et al reviewed a number of empirical studies and found that in the USA, despite increased legal and regulatory focus governing corporate insider actions, insiders are able to extract significant gains from non-public information.²¹³ The preponderance of empirical evidence indicates that insiders tend to purchase more shares than expected before “good news” events like takeover announcements and positive earning news but sell more shares than expected before “bad news” events like bankruptcy and negative earnings news.²¹⁴ But few legal actions have been taken and because it is difficult to prove when insiders obtain private value-relevant information. Thus, the legal and regulatory prohibitions have not been completely effective in preventing insiders from trading using their inside information.²¹⁵

The toughness of the law matters and it has been established that insider trading law quality and profits made from insider trading display a negative relationship.²¹⁶ In countries with high quality and strict insider trading laws enforcement, profits from insider trading is low. ‘The USA is the country where insiders’ profits are the lowest, *ceteris paribus*, but also where insider trading regulation is toughest. The amount of profits realised by insiders is relatively higher in Eastern and Nordic Europe and in Canada and lower in the UK.’²¹⁷ However, by making the market more efficient, the market reaction at the announcement of an acquisition is larger and as a result insider trading laws have the undesirable effect of creating more room for insiders’ profits as they tend to appropriate a larger portion of the total takeover gains.²¹⁸

In 2002, a study of 103 countries that have stock markets revealed that insider trading laws existed in 87 of them but enforcement of these laws are spotty and prosecutions had taken place in only 38 of them.²¹⁹ Various reasons have been advanced for this scenario. It includes a finding that some jurisdictions are not interested in, or are not prepared to devote the necessary resources to implementation of their insider trading

²¹³ JC Bettis et al ‘The effectiveness of Insider Trading regulations’ (1998) 14 (4) *Journal Applied Business Research* 53 at 65.

²¹⁴ Ibid

²¹⁵ Ibid

²¹⁶ Arturo Bris ‘Do Insider Trading Laws Work?’ (2005) 11 (3) *European Financial Management* 267 at 269.

²¹⁷ Ibid

²¹⁸ Ibid

²¹⁹ Bhattacharya and Daouk (note 198) at 75.

legislation.²²⁰ In other jurisdictions the burden of proof on the prosecution is onerous, making it more difficult to secure a conviction whilst in others loopholes exist in the legislation enacted to regulate insider trading which can be exploited by experienced insider dealer.²²¹ It was concluded that enforcement of insider trading laws leads to reduction in the cost of equity and increased liquidity levels in a country.²²²

Durnev and Nain in an empirical study using a sample of 2 827 firms from 21 countries examined insider trading restriction on using private or inside information and reported that on the average insider trading restrictions unambiguously reduced the amount of private information trading.²²³ But where control rights is concentrated in the hands of large shareholders, insider trading regulation is less effective as they resort to covert expropriation of the firms resources.²²⁴ On the other hand, Bris in analyzing a study sample of 4 541 acquisitions from 52 countries found that insider trading enforcement increases both the incidence and the profitability of insider trading.²²⁵

In South Africa, prior to the promulgation of the Insider Trading Act, anti-insider trading provisions were made in the Companies Act 61 of 1973 which yielded no success in criminal prosecutions.²²⁶ Civil remedies were ineffective. The Insider Trading Act had provisions for criminal and civil liabilities. Although no criminal prosecutions were reported, the civil liability provision achieved success in terms of action being taken against offenders and recovering profits, imposing penalties and compensating claimants who were able to prove that they suffered loss in respect of a particular alleged dealing. The Insider Trading Act and its accompanying investigative directorate, Insider Trading Directorate (ITD) operated from 17 January 1999 to 31 January 2005.

‘The ITD was in operation for five years. During its lifetime, 164 insider trading investigations were completed and considered. A total of 136 of the investigations were

²²⁰ Ibid

²²¹ Ibid at 90.

²²² Ibid at 104.

²²³ AA Durnev and AS Nain ‘The Unanticipated Effects of Insider Trading Regulation’ (April 2004) *American Law & Economics Association Annual Meetings, Working Paper No. 23* at 24. Available at: http://law.bepress.com/alea/14th/art_23. (Accessed 31 July 2006).

²²⁴ Ibid

²²⁵ Bris (note 216) at 309.

²²⁶ Luiz (note 178) at 136 – 137.

closed because there was no, or insufficient, evidence of insider trading. All suspicious trading patterns brought to the attention of the directorate were investigated. In 28 cases, the ITD opted to refer the matter to the prosecuting authorities and/or to institute civil action itself. The civil cases are either in the process of going to trial, or have been settled with the FSB.²²⁷ The cases during the time the ITD was in operation culminated in R51 608 589 being recovered and 1 218 claimants benefited from the distribution of the funds.²²⁸

The FSB asserted in its 2005 Annual Report that there was a steady decline in new insider trading cases since the inception of the ITD continued during the period under review but acknowledged that while insider trading has certainly not been eradicated, significant progress has been made.²²⁹ The effort and achievement is commendable.

In 2006 the FSB reported that it registered 22 new cases for investigation.²³⁰ The graph below shows a steady decline of insider trading cases from 78 cases in 1999 to 6 in 2005 but with a substantial increase in 2006 from the previous years. The FSB explained that for the first time, the new cases included possible market manipulation and false reporting matters.²³¹

²²⁷ FSB Annual Report 2005 (December 2005) at 54.

Available at ftp://ftp.fsb.co.za/public/documents/AREport08_2005.pdf (Accessed 14 December 2006).

²²⁸ Ibid

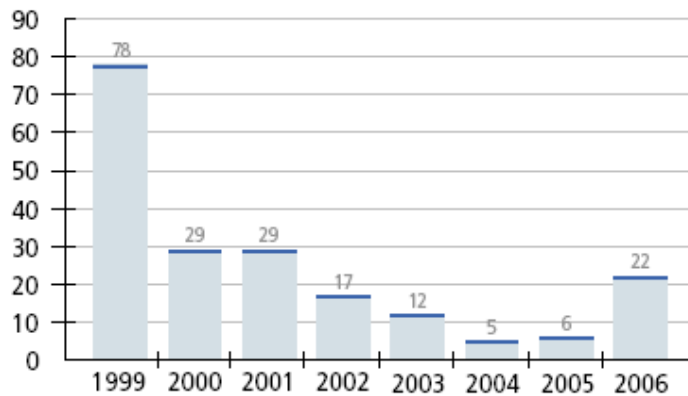
²²⁹ Ibid

²³⁰ FSB Annual Report 2006 (Dated 1 December 2006) at 56.

Available at ftp://ftp.fsb.co.za/public/documents/AREports08_2006.pdf (Accessed 14 December 2006).

²³¹ Ibid

Figure 1: Graph showing insider trading cases investigated by the FSB.



Source: FSB Annual Report 2006²³²

The decline in reported cases shows that the insider trading laws enforcement is effective in reducing the incidence of insider trading in South Africa. However, the reported decline could be due to the fact that insider trading is not being detected by the regulatory authorities. It is better to have a regulation accompanied by good enforcement to serve as a deterrent than no law at all; otherwise it will encourage abusive managerial practices, lawlessness and reduce confidence in the market.

²³² Ibid

CHAPTER 6

CONCLUSION

Insider trading has been associated with capitalism for its entire history. It is regarded as reprehensible for business and society at large. The need for regulation came to fore after the stock market crash in 1929. The regulation started in the United States and spread to other parts of the world. Today most countries with securities markets around the world have passed legislation regulating insider trading. The objective of insider trading regulation is to ensure fairness and integrity of securities market in order to promote investor confidence and reduce systematic risk.

Although, insider trading is illegal in the various jurisdictions, it continues to attract a debate among legal academics economist, lawyers, and politicians and in the media. Deregulators have argued that insider trading is a victimless crime and hurts nobody; instead it makes the market more efficient. The **reality** is that insider trading introduces economic inefficiencies in capital markets and as a result it does not serve the interest of society. It hurts the company, investors and the society at large. It is submitted that insider trading with its inherently unequal access to information to all market participants, kills competition which is necessary for efficient allocation of a society's limited resources. In a country where investor protection is weak and insiders' trade to build their personal fortunes, it discourages investment and reduces the credit rating of the country. More research needs to be done on the real economic costs of insider trading.

The arguments for the prohibition of insider trading are based on market efficiency, fiduciary duty, and misappropriation theory and market fairness. The thrust of the fiduciary duty and misappropriation theory rationale is based on the notion that misuse of information by corporate insiders having a fiduciary relationship with the company or similar relationship with the owner of the information or issuer of the securities undermines management of the corporation and hurt the business. The market efficiency and fairness arguments on the other hand are based on the impact that the utilization of the inside information will have on the market. Thus, the market

efficiency and fairness rationale have a wider scope of application than the fiduciary duty and misappropriation theory rationale. However, insider trading legislation of a country is not based on a single legal theory involving the use of inside information.

Differences exist in the approach to insider trading regulation in various jurisdictions. The intangible nature of information, the ease with which it is communicated and subjected to different interpretation makes drawing up of a comprehensive legislation regulating insider trading a complex issue. No perfect definitions can be drawn for the definition of insiders and the various elements of the offence of insider trading. This has contributed to difficulties in obtaining evidence to prove insider trading cases. Insider trading offence is intrinsically hard to prove and more so proving it beyond reasonable doubt in criminal cases. Hence, few reported insider trading cases have been successfully prosecuted to obtain convictions or none in some jurisdictions as in South Africa. This creates the perception that insider trading laws are weak or ineffective.

In South Africa, the civil liability provisions of the Insider Trading Act and the current legislation, the Securities Services Act have proved to be successful in reducing the incidence of insider trading. However, more work needs to be done. Improving insider trading detection technology, imposing heavier penalties and improving the quality of law enforcement in general will be helpful in combating this corporate crime.

Although regulating insider trading is essential for good corporate governance, overregulation of corporate crimes such as the Sarbanes-Oxley Act of the United States may have unanticipated effects of raising costs to corporations and investors. Some companies are delisting and going private to escape regulatory costs.

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